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FINANCE AND MONETARY POLICY

OF THE

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BANKING, HOUSING, AND URBAN AFFAIRS
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ON

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FEBRUARY 14, 15 AND 17, 1983

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INTERNATIONAL DEBT

MONDAY, FEBRUARY 14, 1983

U.S. Senate, Committee on Banking, Housing, and Urban Affairs, Subcommittee on International Finance and Monetary Policy,

Washington, D.C.

The subcommittee met at 2:30 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, D'Amato, Gorton, Mattingly, Proxmire, and Lautenberg.

Also present: Senator Bill Bradley.

OPENING STATEMENT OF SENATOR HEINZ

Senator Heinz. Today the subcommittee will begin 3 days of hearings on the international debt situation and the proposed increase in the International Monetary Fund quota and GAB.

We will be hearing from the administration represented today by Secretary Regan, bankers and critics tomorrow, and Chairman Volcker and his fellow regulators, Comptroller of the Currency and Chairman of the FDIC on Thursday.

Although these hearings are being conducted within the Subcommittee on International Finance and Monetary Policy, all of the members of the full Banking Committee have been invited, and I have done so because I can think of no more vital topic than health of the international economy and the consequent and safety and soundness of the U.S. banking system.

Secretary Regan, whom we will hear today, recently argued, and I quote, "It is crucially important to our economic interests, to U.S. economic activity: jobs, production and investment, that these debt problems be dealt with in a constructive and orderly way, and the United States cannot escape playing a leading role in that effort."

Let me say that I wholeheartedly agree with the Secretary. Clearly we cannot escape a leading role for two reasons: First, with $100 billion owed U.S. banks, we have the lion's share of the developing countries' debt, like it or not. We are the biggest players in the ball game, and the ball is in our court.

Second, we are the leading economic power by far in the free world. What affects the economy and stability of that world affects us directly. This is especially true where the less-developed countries are concerned, where our Nation also has a lion's share of the developing countries' export market; in fact, we have nearly half.

Indeed, over the past decade, the less developed world has been a faster growing and a more significant outlet for our exports than that of Europe, Japan, and the Communist countries combined. And when we recall that fully 20 percent of our industrial production, 40 percent of our farm acreage, and one job out of six overall in our economy are dependent on exports for their existence, it's not hard to see why a swift and effective resolution of the current debt prices is essential to our welfare and to our future economic growth.

Having said that, I am however still convinced that the current situation would not have fit the description of a crisis had our Nation's banks acted more conservatively and more prudently!

Even if we accept for the sake of argument the bankers' plea that no one could have foreseen the combination of factors which have led to the current debt crisis with a 3-year developed country recession, record-low commodity prices and low or negative growth rates for world trade coupled with high real interest rates, we should still question why our Nation's largest banks with their reputation for steely-eyed skepticism would make multimillion or even multibillion-dollar loans to borrowers in the less developed world based on the assumptions that the prosperity and the inflation of the past decade would never end.

That loans should be made so optimistically seems somewhat contrary to experience.

If one recalls the 1975 or 1976 recession that both the United States and the world experienced, and recalls that it was caused in large measure by the 1973 jump in world oil prices and that that rise was an $8 increase per barrel, should we indeed be surprised that the recession of 1980, 1981, and 1982 following on the heels of that 1979 and 1980 oil shock of $20 a barrel, 2½ times that of the increase in 1973, that this should have led to anything other than the repeat of the kind of economic history and recession that the world experienced less than 7 years before.

I must admit also that I was shocked to read the initial reports last year that some of our largest banking institutions had loan exposures to individual countries approaching 100 percent of their shareholders' equity.

That means in effect the officers of those banks had literally bet the bank on the continued economic health and prosperity of one country.

I was also concerned when I read reports that more than twice the capital of the nine largest U.S. banks is committed to the less developed world. These concerns have led me in joining with my colleagues to begin drafting legislation to provide our regulators with a mandate, the power necessary to impose discipline and prudent limits on our Nation's banks and their international lending.

Some of those limits already exist, though the regulators don't have the mandate to vigorously or effectively enforce them. The legislation we propose to offer will provide that mandate.

I consider that this kind of legislation will be a part of the package this committee considers if it decides on increased quotas for the IMF. I would add that I think my colleagues would agree that we cannot go back to our constituents to justify so large an unforeseen emergency increase in the IMF quota and the GAB, one that involves, as we will hear in a minute, over $8 million in budget authority, unless we can also tell them that we have passed legislation that will prevent a reccurrence of that current kind of debt crisis that has so involved the world, but most specifically, U.S. banks.

We should remember that short term balance of payments type lending to sovereign borrowers on the scale I have been discussing is a comparatively recent activity for U.S. banks.

Prior to the 1970's hardly any of this type of lending was undertaken by commercial banks unless it was in conjunction with a specific IMF program or collateralized by gold, or guaranteed by a third party.

So it is not unreasonable or upsetting of a long, hallowed tradition of the Congress in conjunction with bank regulators to establish rules to guide U S. banks in their international lending.

As I said, I intend to introduce legislation to do that. The establishment of such rules does not mean that there has to be a retreat from commercial bank lending to developed countries, but it does mean that guidelines should be in place to keep countries from living beyond their means, and U.S. banks from getting involved in excessive foreign loan exposure.

One last concern that I want to express relates to the fact that many of the LDC debt service problems have also been attributable to their domestic economic mismanagement and whether the amount of assistance called for via IMF lending will allow the debtor countries to continue to inflate their economies and resist necessary reforms.

In my view we in Congress will need assurances that genuine reforms contributing both to world economic stability and sound international trading practices will be pursued. Having noted my concerns, I would now like to turn to Secretary Regan's testimony, but first I would like to ask if any of my colleagues have any opening remarks.

Senator Proxmire?

Senator PROXMIRE. I'd just like to say very briefly, Mr. Chairman, I'm delighted and honored to join you in that legislation; I certainly support it.

I recognize fully at the same time, of course, that the lending volume by commercial American banks is going to be greater than that the Federal Government will put into this, and all commercial banks—it may be three, four, five times, we hope, greater than the IMF. The IMF is kind of a priming of the pump. It's essential, but the commercial bank lending is important, too.

I recognize that fully, but I think you're absolutely right in indicating that this committee has the responsibility to see that the prudence that has not been exerted in the past will be now.

Senator HEINZ. Senator Gorton?

Senator GORTON. No opening statement.

Senator HEINZ. Senator Lautenberg?

Senator LAUTENBERG. No, thank you, Mr. Chairman.

Senator HEINZ. Senator Hecht?

Senator HECHT. No, nothing.

The CHAIRMAN. Secretary Regan, would you like to begin?

STATEMENT OF DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **Regan**. Thank you, Mr. Chairman, members of the committee. It's a pleasure to appear before you today to explain and support the administration's proposals for legislation to increase the resources of the International Monetary Fund.

After extensive consultation and negotiations among IMF members, agreement was completed last Friday on complementary measures to increase IMF resources: an increase in quotas, the IMF's basic source of financing; and an expansion of the IMF's General Arrangements to Borrow, for lending to the IMF on a contingency basis, if needed to deal with threats to the international monetary system. The Interim Committee and G-10 agreements are included in annex A to my testimony.

These must now be confirmed by member governments, involving congressional authorization and appropriation in our case, in order to become effective. As background to our legislative proposals, which we will submit formally wthin a very few days, I would like to outline the importance to the United States of an orderly resolution of the problems now facing the international financial system, and the key role the IMF must play in solving them.

THE INTERNATIONAL FINANCIAL PROBLEM

Since around the middle of 1982, the international monetary system has been confronted with serious financial problems. The debt problems of Argentina, Brazil, Mexico, and a growing list of other borrowers became front page news. After the oil shocks, their foreign debts began growing much too rapidly. In the inflationary environment of the last decade, they were able to keep on accumulating that debt and failed to take the adjustment measures needed to cool their overheated economies and bring external financing requirements back to sustainable levels.

[See prepared statement for copies of charts which begins at p. 44].

Chart A of the charts that I furnished to you illustrates the buildup of total LDC debt and commercial bank lending to the LDC's. You can see the total debt here and this is the debt to commercial banks and how it has risen from 1973 to 1978.

With the shift to disinflationary world economic conditions, their debts became very difficult for them to manage. Commercial banks involved in international lending took a more pessimistic view of prospects for repayment and began to retrench sharply. As a result, the borrowers have been finding it difficult, if not impossible, to scrape together the money to meet upcoming debt payments.

Chart B illustrates the sharp cutback in new commercial bank lending with LDC's in 1982. You can see the extent of it starting in 1976, rising to its peak in 1981, and then the sharp cutback in 1982. As a consequence, the international financial and economic system is experiencing strains that are without precedent in the postwar era and which threaten to derail the world's economic recovery.

The question is one of speed and degree of adjustment. While the developing countries must adjust their economies to reduce the pace of external borrowing and maintain their capacity to service debt, there is a limit in both economic and political terms to the speed with which major adjustments can be made. Effective and orderly adjustment takes time, and attempts to push it too rapidly can be destabilizing.

The only fast way for these countries to reduce their external deficits significantly in the face of an abrupt cutback in financing is to cut imports drastically, either by sharply depressing their economies to reduce demand, or by restricting imports directly.

Both of these are damaging to the borrowing countries, politically and socially disruptive, and painful to industrial economies like the United States, because almost all of the reduction in LDC imports must come at the direct expense of exports from industrial countries.

THE IMPORTANCE TO THE UNITED STATES OF AN ORDERLY RESOLUTION

It is right for American citizens to ask why they and their Government need to be concerned about international debt problems. Why should we worry if some foreign borrowers get cut off from bank loans? And why should we worry if banks lose money? Nobody forced them to lend and they should live with the consequences of their own decisions like any other business.

Of course, there's more to the problem. First, a further abrupt and large-scale contraction of LDC imports would do major direct damage to the U.S. economy. Foreign trade has become increasingly important to U.S. production and employment over time, and a large part—almost one-third—of any cutback in imports by LDC's has to come directly out of American exports and American export-related jobs.

Chart C illustrates the very rapid expansion of U.S. exports during the 1970's. Trade was the fastest growing part of the world economy in the last decade, and in the latter part of the decade, U.S. exports grew more than twice as fast as total world exports.

You can see U.S. exports this year. The world is in the light red. That is on an index based upon 100 in 1970.

As a result of the growth shown in chart D, the next chart, U.S. exports in 1980 accounted for 19 percent of total U.S. production of goods compared to only 9 percent 10 years earlier. Here it is at 9 percent in 1970, 19 percent in 1980, that is, U.S. exports as a percent of total U.S. goods output.

The surplus agriculture trade shown in chart E rose from $1.6 billion in 1970 to $24.3 billion in 1980.

You can see what is happening in the agricultural area in our total surplus. U.S. trade in services—for example, shipping, tourism, military sales, construction abroad, investment income, interest earnings—has become an enormous source of strength for the U.S. external position and the U.S. economy. Now the U.S. trade balance in services, which is illustrated in Chart F, rose from $3 billion in 1970 to $34 billion in 1980 and an estimated $38 billion in 1982.

By 1980 the U.S. export-related jobs totaled some 5.1 million, which was also 5.1 percent of total civilian employment. As indicated on this next chart, chart G in the set that you have, this represented an increase of over 75 percent in export-related jobs during the decade of the 1970's.

And in 1980 each $1 billion of U.S. exports was estimated to result in 24,000 jobs. You can see the increase from the blue to the yellow, the increase in jobs from 2.9 to 5.1 million in the decade of the 1970's.

Chart H shows that nearly 30 percent of U.S. exports go to the non-OPEC LDC area, representing a market of nearly $6 billion for U.S. goods in 1980.

There's your total exports, this is the exports, to the LDC's. This over here, again to less developed countries. Any sharp cutback in LDC imports will have to come in large part at the expense of U.S. exports and the jobs that depend upon them.

Second, on the banking side, there are indirect impact of concern to all Americans. A squeeze on earnings and capital positions from losses on foreign loans not only would impair banks' ability to finance world trade but also could ultimately mushroom into a significant reduction in their ability to lend to domestic customers and cause an increase in the cost of that lending.

Third, the U.S. Government itself also faces a potential exposure through Federal lending programs administered by the Eximbank and the Commodity Credit Corporation. This exposure, built to promote U.S. exports, amounted to $35 billion at the end of 1982, including $24 billion of Government credits, mostly from the Eximbank, and $11 billion of guarantees and insurance.

U.S. TAXPAYERS FACING LOSS

Argentina, Brazil, and Mexico are high on the list of borrowers. Should loans extended or guaranteed under these programs sour, the U.S. Treasury, meaning U.S. taxpayer, would be left with the loss.

And fourth, if the international debt situation were handled badly and financing were cut back drastically again this year, the difficulties facing LDC borrowers might appear so hopeless to them that they would be tempted to take desperate steps to try to escape.

Even if they managed somehow to make large balance of payments adjustments for a second consecutive year, the United States and other industrial countries would then have to suffer large export losses once again.

At the early stages of U.S. and world economic recovery we are likely to be in this year, another major drop in export production could abort the gradual rebuilding of consumer and investor confidence that we need for a sustained recovery.

But that's not the end of it. In fact, many borrowers have already made very difficult adjustments to get this far. They might not be able to do so again. If they were forced to contemplate a second year of further massive cutbacks in available financing, they could be driven to consider other measures which could lead to widespread banking losses.

IMPACT OF LOSSES IN FOREIGN LOANS

Losses in foreign loans could over time lead to a significant erosion of the underlying capital of U.S. banks. Banks are required to maintain an adequate ratio between their capital and their assets—assets which consist mainly of loans. For some, shrinkage of their capital base would force them to cut back on their assets—meaning their outstanding loans—or at least on their new lending. That cutback would be a large multiple of their loss of capital. Banks would thus be forced to make many fewer loans to all borrowers, domestic and foreign and fewer investments in securities, such as municipal bonds. Reduced access to bank financing would not only force a cutback in the expenditures which private corporations and local governments can make, but it would also put upward pressure on interest rates.

The usual perception of international lending is that it involves only a few large banks in the big cities, concentrated in half a dozen States. The facts are quite different. There are probably several hundred U.S. banks with foreign lending exposures big enough to make a significant dent in their capital and their ability to make new loans here at home. Banks in most States are involved, and the more abruptly new financing for troubled borrowing countries is cut back, the more likely it is that the fallout from their problems will feed back on the U.S. financial system and weaken our economy.

RESOLVING THE INTERNATIONAL FINANCIAL PROBLEM

Debt and liquidity problems did not come into being overnight, and a lasting solution will take time. We have been working on a broad-based strategy involving all the key players—LDC governments, governments in the industrialized countries, commercial banks and the International Monetary Fund. This strategy has five main parts:

First, and in the long run most important, must be effective adjustment by borrowing countries.

The second element of our overall strategy is the continued availability of temporary balance of payments financing from the IMF, on a scale sufficient to help see troubled borrowers through the adjustment period. The IMF role is critical and crucial, not just because of the financing it provides, but more importantly because that financing is associated with policy conditions designed to bring about adjustment by borrowing countries. I will return to this topic shortly.

The third element in our strategy has been the willingness of governments and central banks in lending countries to act quickly to respond to debt emergencies when they occur. The need is to respond in exceptional cases where systemwide dangers are present, to "bridge" the time it takes for negotiations with the IMF and other creditors.

The fourth essential element in resolving debt problems is continued commercial bank lending to developing countries that are pursuing sound adjustment programs. Commercial banks have historically been the largest single source of LDC financing in the past, and this will have to be the case in the future as well.

The final aspect of our strategy is to restore sustainable economic growth and to avoid protectionism which threatens longrun growth prospects and our balance-of-payments adjustment efforts of the borrowing countries.

THE ROLE AND RESOURCES OF THE IMF

I have stressed the role of the International Monetary Fund in dealing with the current financial situation, and now I would like to expand on that point. IMF financing is provided as part of its broader systemic responsibilities as the world's central international monetary institution. Its loans to members are made on a temporary basis in order to safeguard the functioning of the world financial system. They provide borrowers with an extra margin of time and money which they can use to bring their external positions back into reasonable balance in an orderly manner, without being forced into abrupt and more restrictive measures to limit imports.

The conditionality attached to IMF lending is designed to insure that such adjustment takes place. In addition, a borrower's agreement with the IMF on an economic program is usually viewed by financial market participants as an international seal of approval of the borrower's policy, and serves as a catalyst for additional private and official financing.

The money which the IMF has available to meet its members' temporary balance-of-payments financing needs comes from two sources: quota subscriptions and borrowing from its members. The first source, quotas, represents the Fund's main resource base and presently totals some SDR 61 billion or about $67 billion at current exchange rates.

By the beginning of this year, while the Fund still had about SDR 28 billion available for lending, two-thirds was committed to existing programs and to programs about to be initiated. Given the scope of today's financing problems, requests for IMF programs by many more countries must be anticipated over the next year, and it is probable that the IMF's ability to commit resources to future adjustment programs will be exhausted by late 1983 or early 1984. If the Fund is to continue playing its crucial role in addressing world financial problems, its resources will have to be expanded before that happens.

At the beginning of the current quota discussions in 1981, many IMF members favored a doubling or a tripling of quotas. We proposed what we felt to be a more effective alternative, with two components:

First, a quota increase which, while much smaller than many others had wanted, could be expected to position the IMF to meet members' needs for temporary financing in normal circumstances.

Second, establishment of contingency borrowing arrangements that would be available to the IMF on a standby basis for use in situations threatening the stability of the system as a whole.

This approach has been adopted by the IMF membership, in agreements reached by the major countries in the Group of Ten in mid-January, and by all members at the IMF's interim committee meeting last week.

The agreed increase in IMF quotas is 47 percent, an increase from SDR 61 billion to SDR 90 billion, or in current dollar terms, an increase from $67 billion to $99 billion. Our share in the proposed quota increase is SDR 5.3 billion or $5.8 billion at current exchange rates, which represents just over 18 percent of the total increase.

The Group of Ten, working with the IMF's Executive Board, has agreed to an expansion of the IMF's general arrangements to borrow from the equivalent of about SDR 6.5 billion at present to a new total of SDR 17 billion and to changes in the general arrangements to borrow to permit its use under certain circumstances to finance drawings on the IMF by any member country. Under this agreement, the U.S. commitment to the GAB would rise from $2 billion to SDR 4.25 billion, equivalent to an increase of $2.7 billion at current exchange rates.

In sum, the proposed increase in U.S. commitments to the IMF totals the equivalent of $8.5 billion at current exchange rates, $5.8 billion for the quota increase and $2.7 billion for the GAB increase.

While this is the first time I have appeared before Congress to support these specific agreements and proposals to increase IMF resources, the general issues and outline are familiar to members of the committee. Many of you have expressed questions about these proposals, and I would like to discuss the main concerns now.

First, is the IMF "foreign aid"?

Many perceive money appropriated to IMF use to be just another form of foreign aid, and question why we should be providing United States funds to foreign governments. The IMF is not a development institution; it is a monetary institution. Only one of its many functions is providing balance of payments financing to its members, in order to support orderly functioning of the monetary system, and only then on a temporary basis, after obtaining agreement to the fulfillment of policy conditions.

We have been working very hard with the IMF to insure that both the effectiveness of IMF policy conditions and the temporary nature of its financing are safeguarded.

IMF conditionality has been controversial over the years, with some observers worrying that the conditionality is too weak, and others believing the conditionality is too tight, that it imposes unnecessary hardships on borrowers and stifles economic growth and development.

Such generalizations reflect a misunderstanding of IMF conditionality. When providing temporary resources to a country faced with external financing problems, the IMF seeks to assure itself that the country is pursuing policies that will enable it to live within its means—that is, within its ability to obtain foreign financial resources. It is this that determines the degree of adjustment that is necessary. It is often the case that appropriate economic policies will strengthen a country's borrowing capacity and result in both higher import growth and higher export growth.

MEXICO'S SEVERE DEBT PROBLEMS

In this connection, I would cite the example of Mexico as an immediate case in point. Mexico is our third largest trading partner after Canada and Japan. And as recently as 1981, it was a partner with whom we had an export boom and a substantial trade surplus.

This situation changed dramatically in 1982, as Mexico began experiencing severe debt and liquidity problems. As a result, U.S. exports to Mexico dropped by a staggering 60 percent between the fourth quarter of 1981 and the fourth quarter of 1982. Our $4 billion trade surplus with Mexico in 1981 was transformed into a trade deficit of nearly $4 billion in 1982, due mainly to an annual average drop in U.S. exports of one-third. This $8 billion deterioration, which is illustrated in chart I was our worst swing in trade performance with any country in the world, and was due almost entirely to the financing problem.

You can see here exports to Mexico, imports from Mexico, and what happened to our trade balance, as I described it in 1982. We had a severe drop in our exports.

We believe that now this situation will start to turn around, and we can begin to resume more normal exports to Mexico. If this hapens, it will be due in large part to the fact that, late in December, an IMF program for Mexico went into effect. This program and the financing associated with it will permit resumption of more normal levels of economic activity and imports. Without the IMF program, all we could look forward to would be ever-deepening depression in Mexico and still further declines in our exports to that country.

There is another aspect of the distinction between IMF financing and foreign aid which we should understand clearly, since it goes to the heart of the United States' relations with the Fund. All IMF members provide financing to the IMF under their quota subscriptions, and all—industrial and developing alike—have the right to draw upon the IMF. Our own quota subscription has been drawn upon many times—and repaid—over the years for lending to other IMF members. But we have in turn drawn on the IMF on 24 occasions—most recently November 1978—and our total cumulative drawings, amounting to the equivalent of $6.5 billion, are the second largest of any IMF membership. Detail on those U.S. drawings from the IMF is provided in annex B to my statement.

Another question. Why spend money on the IMF?

Another major concern with the proposals to increase IMF resources is that, in this period of budgetary stringency, many believe we would be better advised to spend money at home. There is also some feeling that if we were to get the U.S. economy moving forward again, the international financial problem would take care of itself.

We will do what is necessary domestically to strengthen our economy. But we will leave a major threat to domestic recovery unaddressed, if we do not act to resolve the international financial situation. The direct impact alone of international developments on our economy is so large that were the international situation not to improve, there would be at a minimum a tremendous drag on our economic recovery.

It is true that an improving U.S. economy is going to help other nations, both through our lower interest rates and through an expanding U.S. market for their exports—providing, of course, that we don't cut them off from that market. But they also have an immediate short-run financing crunch to get through, and if we don't handle that right, there are substantial downside risks for the United States.

EFFECT OF INCREASE IN IMF RESOURCES

This might also be the right context in which to discuss how U.S. participation in the increase in IMF resources would effect the Federal budget and the Treasury's borrowing requirements. Because the United States receives a liquid, interest-earning reserve claim on the IMF simultaneously with our actual transfers of cash to the IMF, these transfers do not result in net budget outlays or an increase in the Federal budget deficit.

However, actual cash transactions with the IMF, under our quota subscription or U.S. credit lines, do affect Treasury borrowing requirements. The amount in any year depends on a variety of factors, including the rate of use of IMF resources; the degree to which the dollar is used in IMF drawings and repayments to the IMF; and whether the United States itself draws on the IMF. On average, there have been increases in Treasury borrowing requirements attributable to IMF transactions, amounting to about $450 million annually over the last 13 years, for a cumulative total of over $6 billion. The rate has picked up in the last two years of heavy IMF activity, as would be expected; but the total is still relatively small—the $454 million average annual impact is only a small part of the $54 billion annual average Federal borrowing requirement over the same period; and the $6 billion cumulative impact compares with an outstanding Federal debt of $1.2 trillion at the end of 1982.

Annex C in my prepared statement contains details on the budgetary, financing and accounting aspects of our relationship with the IMF.

Is the IMF increase a bank bail out?

I know there is widespread concern that an increase in IMF resources will amount to a bank bailout at the expense of the American taxpayer. Many would contend that the whole debt and liquidity problem is the fault of the banks—that they've dug themselves and the rest of us into this hole through greed and imcompetence, and now we intend to have the IMF take the consequences off their hands. This line of argument is dangerously misleading, and I would like to set the record straight.

First, the steps being taken to deal with the financial problems, including the increase in IMF resources, require continuing involvement by the banks. Far from allowing them to cut and run, orderly adjustments require increased bank lending to troubled borrowers that are prepared to adopt serious economic programs. That is exactly what is happening. For example, the banks are putting more than $10 million of new money into Argentina, Brazil, and Mexico in 1983.

It is also a mistake to think that the increase in IMF resources is coming mainly from the United States.

The U.S. share in the increase in IMF quotas is 18 percent, which means other countries are putting up the remaining 82 percent, the great bulk of the increase. This will keep our voting share slightly over 19 percent, which will maintain our veto over major

IMF decisions and provide a needed margin of protection for the future. Some of our allies would claim we aren't pulling our own weight, that our stake in world trade and finance is bigger than the share of resources we are proposing to put in the IMF would indicate.

SCREENING FOREIGN LOANS

The third point I would like to make is the whole debt and liquidity problem cannot fairly be said to be the fault of commercial banks. In fact, the banking system as a whole performed admirably over the last decade in a period when there were widespread fears that the international monetary system would fall apart for lack of financing in the aftermath of the oil shocks. The banks managed almost the entire job of recycling the OPEC surplus and getting oil importers through that difficult period. Some of the innovations and decisions that banks made in the process, which seemed rational and necessary at the time to them and to others, may seem doubtful in retrospect, given the way the world economic environment has changed. But I think we can agree that governments have had a great deal to do with the shaping of that environment.

All of this is not to say that there aren't lessons to be learned in the banking area. There clearly has been an element of lack of prudence in lending decisions and of overlending. So we should be asking ourselves, what is there that banks could be doing to improve their screening of foreign loans? What is there that bank regulators could do to improve their analysis of country risk, examination of bank exposure, and consultation with senior management? Both in the banking regulatory agencies—that is, the Fed, the Comptroller, the FDIC—and in the Treasury. We will be reviewing these and other issues to see what changes may be desirable.

Chairman Volcker, Comptroller Conover, and FDIC President Isaac are scheduled to appear before your subcommittee on Thursday to discuss these matters in detail.

Now, Mr. Chairman, in conclusion, the IMF plays a crucial role in the solution to current debt and liquidity problems and providing the environment for world recovery. It is absolutely essential that the proposed increase in IMF resources become effective by the end of this year to enable the IMF to meet these responsibilities.

Prompt U.S. approval is important, not only because the financing is needed, but also because it would be a sign of confidence to other governments and to the public that will help lay to rest concerns about the risk to global recovery.

But more importantly, timely approval of these proposals is essential to our own economic interests, to the prospects for American business and American jobs. The legislation to give effect to these proposals will be submitted to you in a very few days, and I urge that you give it prompt and favorable consideration.

Thank you, Mr. Chairman.

[Complete statement is printed at p. 44].

Senator **Heinz**. Mr. Secretary, thank you very much. I think you made an excellent presentation, and I myself believe it is absolutely essential for the Congress to take up your proposals, deal with them, enact them, notwithstanding the fact there are some safeguards we may want to enact at the same time.

I think you made an extremely persuasive case as to why an increased IMF authorization and the increase in the general agreement to borrow is in our interest.

I would only add, in fact, one point that you didn't make, and that is that we will be putting up roughly 19 percent of the increased quota, yet we benefit to a far larger extent in the share of LDC trade, as I understand your presentation.

Therefore, is it not correct that we will be a disproportionate beneficiary of any improvement in world trade to come about through this? Is that correct or not?

Secretary REGAN. That is very correct, Mr. Chairman. I should have thought of it. I had enough of that from my fellow finance Ministers as they were trying to get me to increase the amount that we would agree to the IMF quotas.

Senator HEINZ. As I understand the other thrust of your argument, you are saying that trade and exports of this country will benefit, that we will, by securing the world financial system, obviate any problems on the $35 billion that such institutions as the Export/Import Bank have at risk abroad, that by insuring that our banks do not end up with significantly more classified or problem loans, we would insure a more available supply of credit in this country, which you explained the mechanics of that, and you explained that this is not an issue that involves just a few large banks but there are several hundred banks involved.

I would like to focus on the specific issue of jobs, which is something that we are, you know, in short supply of, far too short supply.

It is my recollection that you made a point before the House Banking Committee that the failure to enact this legislation stabilizing the world monetary system could mean the loss of 1 percentage point from USA growth this coming year, the year we are now in, 1983.

Is that correct?

Secretary REGAN. That is correct, Mr. Chairman.

Senator HEINZ. What would that mean in the way of jobs?

Secretary REGAN. Well, it is usually felt that somewhere, probably in the neighborhood of a quarter of a million jobs, would be a casualty as the result of a drop of 1 percent in GNP.

Senator HEINZ. A quarter of a million jobs. Those are very high stakes, indeed.

Secretary REGAN. Oh, yes.

Senator HEINZ. Now to turn critic for a moment of the increase in the IMF quota, there is some concern, which to a certain degree I share, that there is a balance that one wants to achieve in this kind of operation.

On the one hand, if the application of reforms through conditionality is too strict, the less developed countries will be unable to regain their feet, and export markets will not develop the quarter of a million jobs that you have just described will not be available to us, and that is clearly the issue, in effect, the expansion of borrowing facility is intended to address.

The other side of that coin is that too large an increase in the quota, or for that matter the combined quota and GAB, will finance the continuation of overly expansionary measures by the LDC; that it will allow them to continue to do what they have done too much of in the way of their domestic expansionary and inflationary programs and, indeed, take into possibly the worst dimension, from our point of view, it may even allow them to subsidize exports into the international marketplace and precipitate other kinds of crises, destabilizing international trade.

How can you assure us against the over expansionary use of these resources by the International Monetary Fund?

Secretary **Regan**. First of all, the Executive Directors of the Fund pass on all of these loans to all of these countries and programs. We have an Executive Director who represents the interests of the United States. That is one of his chief assignments, to examine these programs and to make sure that hopefully they are neither too stiff nor too loose as far as the country is concerned.

Second, with limited resources and even with this increase in quotas, many would still believe that the IMF's resources are limited. They are not likely to spread them around too generously, and they want to keep a lot in reserve because they don't know what the problems will be tomorrow or, indeed, another tomorrow, because theoretically these quotas are for 5 years, and this money is supposed to last for another 5 years.

That being the case, I think they will husband their resources pretty well at the IMF. I also have a great deal of confidence in the Managing Director, Mr. de Larosiere.

Senator **Heinz**. Now, Mr. Secretary, you yourself in your testimony addressed certain questions that we have all been asking—you have asked them yourself—as to what banks could be doing for further screening of their foreign loans, what regulators can do and so forth. And, indeed, I think a question virtually every Senator and Member of the House will have to be prepared to answer to their constituents is how to explain to people the apparent preference that the big American banks have been giving in big loans to foreigners abroad when Americans haven't been able to borrow affordably to buy a home or a car here at home.

And to a certain extent, we can look back and say that we disagreed with those things, but the constructive way to address the issue is how are we going to prevent these things from recurring, at least to the best of our ability.

Specifically, what do you suggest we ask the bank regulators to do, or what do you suggest we ask the banks to do to the extent that they have been imprudent—and I believe some of them have been very imprudent—to the extent they have been greedy—and I believe some of them have been very greedy—that we can prevent the kind of overextension of credit, which worries us and you so much today?

COUNTRY LOAN LID

Secretary **Regan**. I think there are several things that you could ask the regulators to do. I would think the Congress itself would not want to get into the specifics, but would insist that the regulators do that. I am not sure that the Congress would have the time or the inclination to want to spend that amount of time looking at details of loans that would be granted by any one of several hundred banks to various foreign countries.

But I do think that you have a right to ask whether some type of country loan lid should be put on. I think that is a natural question.

Senator **HEINZ**. Indeed, for practical purposes, do we not have a sovereign risk limit for nonmarket economies?

Secretary **REGAN**. In most cases we do, but it has not really been limiting.

I think the other thing that has to be done, because situations change from year to year—the recent change in oil prices has changed the conditions of several different countries around the world, some for the better, some for the worse—at that point in time I think a bank has to review its policies. I don't think you can just say a credit is a credit—that an obviously good credit in year one would necessarily be an obviously good credit in year two, three, four, or five.

They must constantly review these. I think the regulators themselves should constantly be alert to this so that they can discuss with the senior executives of the institution why are they still lending to such and such a country if, indeed, that country is getting into trouble. I think it is that type of thing that the banks have to stay on top of.

TRADING CREDIT INFORMATION

Senator **HEINZ**. What about more reliable exposure or credit information? Do you think our banks have adequate information on the extent to which, in aggregate, themselves and other banks are exposed?

Secretary **REGAN**. This gets us into an interesting question, Mr. Chairman, which I think this committee should deal with. It has overtures of antitrust implications in it, but nonetheless I think it is something you have to come to grips with.

Will the banks be allowed to trade information among themselves as to just how much they have in loans with foreign institutions, or is this information just to be made specific to the regulators?

I take a case in my own background, the case of the famous silver debacle of a few years ago. We were amazed to find how much in the way of loans had been given to certain parties by banks, by brokerage firms, and the like, none of whom knew what the other one was doing, each one thinking that it probably was the lead institution, if not the only institution, providing loans.

But how can you allow 100 banks to swap this type of information? I think that you will have to address this one very gingerly. The banks should be allowed to exchange information, but I think they are probably going to have to have a lawyer present so as to avoid the antitrust implications of what they are doing.

Senator **HEINZ**. One other suggestion we'll be looking at is the way to treat loan loss reserves. Do you have any comment on that?

Secretary REGAN. That one I'm going to leave specifically to the Comptroller and to the FDIC. I know they're working on that problem.

I, too, would be interested to hear what they have to say.

Senator HEINZ. Mr. Secretary, thank you very much. My time has expired.

Senator Proxmire?

Senator PROXMIRE. Thank you, Mr. Chairman. Mr. Secretary, congratulations on a very fine statement. It's extremely thoughtful on a most complicated and difficult issue.

I suppose the most overwhelming economic problem we face in the Congress is the size of the deficit, the continuing size of the deficits we face for the next 3, 4, 5 years.

We have the most colossal deficit we've had in peacetime. No matter what the relationship is, the size of the GNP et cetera. $200 billion at least this year, maybe bigger.

The Managing Director of the IMF, Jacques de Larosiere, who is an expert, has said that the American budget deficits are the most serious problem facing the world economy.

You say that this IMF replenishment that we would provide of $8.5 billion would not be a budget item, but you can see that it does require Treasury borrowing, and then you explain how it would play out.

At the same time it would seem to me that this $8.5 billion borrowing by the Treasury is something that this committee and the Senate and the House must be very concerned about.

CROWDING OUT PRIVATE SECTOR BORROWING

I would like to ask you if it could have the effect—would have the effect of crowding out some private sector borrowing, for whatever purposes.

Secretary REGAN. Good question, Senator. As a matter of fact you're entirely right that the Congress should be concerned with this. I kept using the Congress name, I hope not in vain, in my arguments that we could not take the IMF quotas up to the limits that a lot of other countries would have wanted in doubling and tripling, because I said the Congress was very concerned with this, and rightfully so.

Let's break it down into the two pieces. First, to get an answer to your question: $5.8 billion is the authorization, budget authorization we will be seeking for the IMF quotas: about $2.6 billion for the General Arrangements to Borrow.

Looking at the $5.8 billion first, that will be called upon over the next several years. We don't know at what rate, but the rate of the last 2 years would indicate maybe one, maybe one and a half billion dollars per year over the next several years.

Senator PROXMIRE. Let me interrupt you, as that means we would be borrowing only one and a half to a billion dollars a year or so each year; is that right?

Secretary REGAN. Each year, and this year, as you know, Treasury's going to borrow something in the neighborhood of probably $240 billion. So, it's slight in comparison, although I regret I have to phrase it that way. But would that crowd out in and of itself? No.

The $2.6 billion is a standby; that's the General Arrangements to Borrow. That will hopefully never be touched—only if the IMF is in a very serious condition, which would mean that its other funds were inadequate, and then would have to tap this insurance fund.

So we don't anticipate that there would be very heavy borrowings indeed, if any, of that particular portion over the next several years.

Senator PROXMIRE. Where does it say that the GAB would be used last?

Secretary REGAN. Would be used last? I'll quote to you from our communique which describes that.

Senator PROXMIRE. Would that be in the legislation?

Secretary REGAN. The description of what the general agreement would be is in there. I'm quoting here from our communique. It's agreed "in the future the GAB would be available not only for drawings by participants, but also for purchases from the Fund for conditional financing for all its members, including members that are not GAB participants, when the Fund was faced with an inadequacy of resources arising from an exceptional situation associated with requests from countries with balance of payments problems of a character or aggregate size that could cause a threat to the stability of the international monetary system." In other words, the Fund itself would have to be pretty well exhausted before——

Senator PROXMIRE. In your judgment, how much would actually be borrowed by the U.S. Treasury in 1984 for this purpose?

Secretary REGAN. For this purpose? A guess—and I always get in trouble guessing before Senate committees—would be a billion to a billion and a half, and certainly not over two billion dollars.

Senator PROXMIRE. $1.5 to $2 billion. All right, then, some people argue that this short-term lending just papers over a situation which is far more fundmental. What we should do is be converting the short-term lending into long-term loans, and the interest rates should be reduced. And there would have to be some losses taken, I presume, but this is necessary because of the plight of the LDCs.

Secretary REGAN. I would not want to see the IMF reduce its terms on its loans. I think the IMF was set up at Bretton Woods for the purpose of promoting monetary stability; it has done well in the intervening, almost 40 years. I see no reason for the IMF to do that. I think banks are the ones that should have to take that burden.

Senator PROXMIRE. Is it your position the banks should also assume whatever losses are involved here?

Secretary REGAN. Sure, if there are going to be losses, they should be the banks', not the IMF.

Senator PROXMIRE. Not the IMF and not the U.S. Treasury?

Secretary REGAN. Exactly. By the way, no one has ever defaulted on an IMF loan.

Senator PROXMIRE. When domestic credits are weak, bank examiners classify loans substandard, doubtful, or loss and loans are required to be written down. I understand the regulators are reluctant to classify countries as loss for understandable reasons.

Wouldn't it make sense for the Federal Reserve to have the authority—I'm not talking about "are doing it," but have the authority to require reserves to be set-aside by banking institutions to apply to the risk in international lending?

Secretary REGAN. At least some of the regulators, whether it's the Federal Reserve Board, the Comptroller, or the FDIC, but certainly some of the regulators should have that authority.

$300 MILLION IN UP-FRONT FEES

Senator PROXMIRE. There have been reports in connection with the restructuring of loans to countries that can't pay that which they originally contracted for, the banks derived up-front fees that were taken into the income account the first year. I think the reports that I saw stated that something like $300 million were awarded in up-front fees. Thus at a time when the loans' portfolio may be weaker, the banks' income appears to be increasing.

Shouldn't the Federal Reserve adopt a rule requiring such fees to be amortized over the remaining life of the loans and be used to reduce the size of the loans?

Secretary REGAN. I thought about that one, Senator, that's——

Senator PROXMIRE. Let me just interrupt to say it's my understanding there was no disagreement on the part of the banks that the profits were very large on these fees and that they weren't—didn't have to cover any actual——

Secretary REGAN. You know, that is not unique to country borrowers when you have to renegotiate any loan, be it a corporation, individual, or what have you. The banks usually charge another bank at the time of renegotiation. As to whether it should be amortized or not, that's purely a matter of judgment as to how that impacts on the earnings of the bank in any one year.

Very complicated. There's no simple answer to that one.

Senator HEINZ. If the Senator would yield, sir, would you favor giving the bank reserves or bank regulators the flexibility, though, to set forth regulations governing the amortization of fees?

Secretary REGAN. Yes, but not the size or anything of that nature. I think that should be a matter of negotiation between the parties.

Senator PROXMIRE. In answer to a question asked by the chairman, you indicated agreement—not the overall quota—is 18-19 percent or something like that. You indicated that that was—you agreed that that was a lesser proportion than our share of the trade and therefore we would be a disproportionate beneficiary.

But aren't there only certain currencies that are usable for balance-of-payment conditionality loans, and aren't those the dollar and the pound, and the mark and the yen, so that others are excluded, so that wouldn't our contribution therefore be greater perhaps, 30 to 35 percent, and therefore more in relationship to benefit——

Secretary REGAN. I would have to do the arithmetic, and this requirement of putting up quotas. All of the nations, be they small, large, developed, developing or industrialized, all have to put up at least 25 percent of their quota in usable currencies, usable currencies of the SDR basket of currencies, which are the so-called G-5 currencies which you just mentioned plus the franc.

So I would have to do the arithmetic, but maybe one of my staff has an answer to that.

We will have to submit that for the record, Senator.

[The following was received for the record:]

IMF USE OF DOLLARS

Question. Won't drawdowns on the U.S. quota subscription (and corresponding Treasury borrowing requirements) be much greater than the U.S. share of IMF quotas because the dollar represents a very high proportion of the IMF's usable currencies?

Answer. Probably not, over any extended period.

All IMF Members have a legal obligation to permit their currencies to be used to finance IMF drawings by other countries. If a member's currency is not widely used in international transactions, the issuer must stand ready to convert any IMF balances of its currency used in IMF drawings into a "freely usable" currency—currently dollars, pounds sterling, deutsche marks, yen, and French francs (Article V, Section 3(e)(f)).

All IMF currency holdings are therefore usable to finance drawings, depending on the strength of the country's balance of payments and reserve position, exchange market developments, and the desirability of promoting balanced use of currencies over time. The IMF assesses each member's external position on a quarterly basis, and on the basis of that assessment establishes a list of currencies to be used in financing drawings during the coming quarter.

The list varies over time depending on balance of payments developments and the proportions of individual currencies to be used cannot be predicted reliably.

The dollar has been excluded from the list of usable currencies for extended periods, e.g., during 1971-73 and 1978-79, and the U.S. quota subscription has generally not been used during such periods to finance IMF drawings. Indeed, during such periods the dollar is normally used in repayments to the IMF, resulting in net inflows of dollars to the Treasury and consequent reductions in Treasury borrowing requirements.

For the current quarter, the dollar's share of expected use of currencies in IMF drawings is 32 percent.

From a longer-term perspective, however, drawings on the U.S. quota subscription have not financed a disproportinate share of total IMF drawings.

The U.S. quota share has averaged about 26½ percent of total IMF quotas over the life of the IMF.

Total currencies drawn from the IMF since 1947 have amounted to the equivalent of about $65 billion (at current exchange rates).

Of this gross total of currencies drawn from the IMF, it is estimated that a maximum of some $14 billion, or about 22 percent, was financed from the U.S. currency subscription. (Net use of the U.S. currency subscription is of course much smaller, currently totaling about $2.8 billion.)

Thus, while the dollar is on the current currency budget and, given the strength of the dollar and the U.S. external position, should be expected to be used fairly heavily in financing IMF drawings over the period immediately ahead, there is no reason to expect disproportionate use of the U.S. quota subscription over time.

Senator PROXMIRE. Thank you, Mr. Chairman, I have no further questions.

Senator HEINZ. Senator D'Amato?

Senator D'AMATO. Thank you, Mr. Chairman. Certainly Mr. Secretary, I appreciate the cogency of those arguments that you put forth, and recognize the necessity of moving in such a way as to not create additional problems with regard to the troubled international monetary system.

Nevertheless, I am sure that you can appreciate the concerns which we have over the pending proposal dealing with the IMF. This request, for a significant increase in the U.S. contribution to the Fund comes at a time we are faced with many difficult issues affecting the domestic economy. In addition to this general concern, I am particularly concerned over the role of the regulatory agencies in monitoring the foreign loan activities of U.S. banks. Clearly, changes are required in this area. The Congress and the people of the United States are deeply troubled over the current situation and concerned with the prospects for the future. How did the system go wrong? Where were the Federal regulators in connection with the failure to detect the signs of this debacle?

HAPPENINGS THAT BROUGHT ABOUT PROBLEMS

Secretary REGAN. I think it's a confluence of several outside happenings all at once that brought the realization home. Most of these loans, I think, particularly countries such as Mexico, one of the oil-exporting countries, were based upon the fact that the current thinking in the late 1970's and early 1980's, up until perhaps the middle of last year, was that oil prices were going to rise forever, $30, $35, $40, $45 a barrel of oil.

Obviously, if a nation undertakes a loan at $30 a barrel and it goes to $35 or $40, it's a pretty good risk. Conversely, it was felt that many of the developing countries, such as Brazil and Argentina, would see their exports continue to grow.

Now we have both a drop in oil prices and disinflation coming at one time—the prices of all commodities dropped practically simultaneously. Brazil for example is a major exporter of iron ore, of coffee, rubber, soybeans—several major products of that nature. All of these are on the bottom or were on the bottom in the summertime, as Brazil got into this trouble.

It would take quite a matter of judgment to have predicted that all of these commodities would be at the bottom at the same time within such a short period of time.

I don't think any economist really predicted this. There may have been some here and there—I don't wish to denigrate the whole profession, but very few.

I know conventionally most banks never anticipated that; I think that's what led us into the trouble. At the same time the sovereign governments wanted to see social programs pushed within their country, that's only natural, so the political leaders were of a mind to borrow as much as they could in order to promote their programs faster than perhaps was wise.

Senator D'AMATO. Mr. Secretary, the second part of that question, what do we do to insure that we don't have a recurrence.

Secretary REGAN. I think the Congress should come in with a broad charge to the regulators and let the regulators be specific on their own rules rather than try to enact a single law.

If we try to enact regulations into law, I'm afraid we'll get ensnared in a lot of detail and do things unwittingly that couldn't be undone if economic circumstances changed again rapidly, perhaps for the better, perhaps for the worst. Regulators supposedly can move faster than that, and I would hope that under the oversight of the Congress, they would have this charge to be more specific.

Senator D'AMATO. Mr. Secretary, just one last question. Will you be submitting to the Congress a list of those appropriate steps that you feel the regulators should take, in connection with their review of these matters?

Secretary REGAN. I hadn't specifically planned on it, but if this committee desires, naturally I will submit such a list after I see—if I may—what the regulators themselves are going to propose.

Senator D'AMATO. It would be most helpful and appropriate to have your comments with respect to the current role of the regulators and your recommendations to strengthen their important monitoring activities.

Thank you very much.

Secretary REGAN. Will do.

Senator HEINZ. Mr. Lautenberg?

Senator LAUTENBERG. Thank you, Mr. Chairman. Mr. Secretary, it's a pleasure to meet you. It was a very lucid presentation that you made. I have a couple of basic questions since I have had the opportunity to meet with Mr. Sprinkle and other members of your staff. These may be slightly repetitive to them, forgive me.

One is concerning the prospect of borrowing a billion and a half dollars in 1984—we don't like to make predictions, but that always happens, we make them even if we don't want to——

Secretary REGAN. 1984.

GENERAL AUTHORIZATION FOR BORROWING

Senator LAUTENBERG. As I read the papers, it seems to me that this commitment had been made for us already, before any action was taken by the Congress, certainly in the General Agreement to Borrow. That's a commitment that I think doesn't require legislation to support it; is that true?

Secretary REGAN. No, we would also bring the GAB to the Congress for its specific approval. This represents a new dimension in the GAB. The previous one, in 1962, I believe, was approved by the Congress, and we would specifically ask for approval for this increase in our commitment under the General Arrangement to Borrow.

Senator LAUTENBERG. So the commitment is made tentative to getting the appropriate congressional authorization.

Secretary REGAN. Let me explain that to you, Senator. What has happened here is that the Finance Ministers have agreed to this, subject to legislative approval. They will take it to their own Congresses, I'm taking it to our Congress for specific approval.

If we don't get it, there's no money put up.

Senator LAUTENBERG. Fine. It was my understanding at our earlier review that the GAB went first. Is that not correct.

Secretary REGAN. That's correct. That approval was reached in mid-January of the G-10 Finance Ministers. The reason for that, the GAB set up in 1962 is limited to 10 countries. We now propose to expand it to include all IMF member countries as potential borrowers and increase the size of it.

Accordingly, that requires now the full approval of all of the IMF members that they agree to this. And it specifically requires the approval of these 10 countries that they will up their amounts in this standby fund for all of the nations.

Senator LAUTENBERG. I thought you said earlier that the GAB was there only for the direst of emergencies.

Secretary REGAN. It comes last in that respect. It's an insurance fund, a kitty, if you will, held back from regular appropriations of the IMF. But if the situation ever gets that bad where the IMF does not have sufficient resources to meet the demands, or if there's some type of catastrophic situation prevailing in the world's monetary situation, then the GAB is tapped.

Senator LAUTENBERG. I was under the impression that that came first in terms of the Fund. You said something earlier about the United States. We were down, I think, the second largest amount of money, and I looked at the schedule here and the borrowing periods were separated by substantial numbers of years.

Secretary REGAN. The initial U.S. drawing from the IMF was 19 years ago.

Senator LAUTENBERG. Right; no borrowing. But would it be fair to say, Mr. Secretary, that our borrowings were among the most liquid, vis-a-vis meeting the adjustment programs, if we have to submit them. Do we have to submit adjustment programs when we borrow?

Secretary REGAN. No; those were drawings on our own reserves. You can build up reserves through transfers of your currency to the International Monetary Fund. At any time you can draw down on your own reserves, to the extent that they are there. Each time in the past when the United States has drawn, it's only drawn on its own reserves.

It's never drawn under a contingency loan program with the IMF, in which conditions would be set for the loan to be granted.

Senator LAUTENBERG. It would be a multiple of borrowing capability to the quota that we've got. Four times, I think it is.

Secretary REGAN. No; we just draw down the reserves. We could up to 450 percent of quotas if we borrowed from the IMF.

Senator LAUTENBERG. The thing that I was most interested in is that, we thought that this new commitment would take us through several years, if I heard you correctly; and yet we saw that the last time the commitment was made with a projection that would survive over a number of years, that, in fact, it didn't come any where near the projection that was made, though it was contemplated to last for about 5 years. And now there is a need for an additional capital contribution. That's a concern that I would have. I would like to know what kind of assurance we can get so that we not be called on very quickly again.

Senator HEINZ. If the Senator will yield. The reason, Senator Proxmire and I and others on the committee, and I know you are too, are so interested in proposals that will prevent the kind of overextension and recurrence of credit problems is probably the best assurance that we can get with every bit of 5 years, and even more, before ——

Senator LAUTENBERG. I appreciate that, Mr. Chairman. I thought maybe the Secretary had a different point of view.

FREQUENCY OF IMF QUOTA INCREASE

Secretary **REGAN**. Actually, IMF quota increases have become common in frequency. It's almost unseemly—1978, 1980, and now 1983. We have no guarantees we won't need more in another 5 years. We know not what the condition of the world's monetary system will be.

We try to refrain from these, very frankly. We don't like to go through these hassles all the time either within the IMF nor with the Congress. And as a result, we try to avoid these as much as possible, but when it seems that there is peril in the world, I think that we have duty to come back to the Congress, to consult with the Congress as to what the effects will be if we don't have an increase in the quotas. And then Congress in its own wisdom can make the decision along with us—yes, it is needed, or it isn't needed.

But there never will be an increase in the quotas in which the Congress is not consulted.

Senator **LAUTENBERG**. But you say the forecast is as good as any computer forecast would be.

Secretary **REGAN**. Right.

Senator **LAUTENBERG**. Thank you very much, Mr. Secretary. [Laughter.]

Senator **HEINZ**. Thank you.

Senator Gorton?

Senator **GORTON**. Mr. Secretary, assuming the approval of these recommendations and assuming the rather substantial additional private borrowings that are likely to be mandated in connection with the IMF's relationships with the countries in the worst financial condition, do you think, with your views of the way in which the world economy is about to move, that the countries which are in the worst financial shape at the present time, the Mexicos, the Brazils, the Argentinas, are going to be able to work their way out of their present difficulties? Will the loan conditions be such, and will the conditions in the world economy be such as to give these countries a substantial promise of working their way out and repaying the debts which they have now incurred, together with those which they will incur, if we approve this additional subscription?

Secretary **REGAN**. I think, Senator, that there is a good chance that the nations that are currently under or are contemplating IMF programs, that if they enact these IMF programs, and if they stay with the programs, and if the commercial banks put up the additional funds that are necessary to carry these programs out, these countries can emerge and will emerge. I'm quite hopeful on that. However, if you notice, there was a long string of "ifs" in my answer. Anything can happen within this. There can be some other type of event happen to the world's economy, that could prove to be another shocker.

Were that to happen, some of these nations might again get into trouble. That's why we cannot offer you any guarantee. I can assure you that we think if all things remain the same as they are now, that can't happen, but we can, by no means, offer you the advice that, were you to pass this, all of the problems would be over and everybody would emerge happily.

Senator GORTON. So there's at least a distinct possibility that the private banks could end up throwing good money after bad?

Secretary REGAN. That's a possibility. Not a probability, but a possibility. I don't think they have any other choice.

Senator GORTON. Now, are the opportunities or the chances that this funding of the IMF will be successful and these future loans will be successful, enhanced or hurt, if petroleum prices or oil prices continue to decline?

Secretary REGAN. If oil prices continue to decline, there will be some more winners and some losers. You saw, obviously, on Friday, the Consumer Price Index, how a drop in the price of energy is helping inflation within the United States. The same thing will happen in the other industrialized countries and the developing countries. So there will be many winners if that happens.

Were interest rates to drop, many of these countries would be winners. Interest rates could come down. If they do, countries such as Brazil, for example, that's paying probably $10 billion a year in interest, every 1 percentage point would mean about $700 million to them.

Now from the point of view of a nation that is an exporter of oil, this could be very harmful, and there are several of the oil-exporting nations that will have problems with a further decline in the price of oil.

Senator GORTON. Will it be the policy of the Department of the Treasury or the administration to encourage further cuts in oil prices?

Secretary REGAN. We would certainly like to see further declines in the price of oil, speaking for Treasury. From our point of view, this would be very helpful to our own domestic economy, long range. There may be some temporary turbulence for our own oil producers here, domestically. There may be difficulties with some of our banks, domestically. But, nonetheless, long range, I think it's a very healthy thing for our economy.

Senator GORTON. On another subject, Mr. Secretary, granted that almost all of us have 20-20 hindsight, is it your view that all or most of the loan policies of our larger private banks were wise investment policies at the time at which these loans were made?

Secretary REGAN. That's a whole mouthful to swallow, Senator, to speak for all of the loans made by all of the large banks. I would have to say that most of them, in my judgment, from what I know of them, were probably wise at the time, but certainly not all.

Senator GORTON. To the extent that they were wise at the time, is there any reason other than simply making this set of policies you have advised more politically palatable for us to pass statutes restricting the activities of banks in the foreign loan department? Are we likely to have any better foresight as to what is needed in the near or distant future than the banks had a few years ago?

CAUTION IN PASSING SPECIFIC LAWS

Secretary REGAN. Again, I caution the Congress on passing specific laws limiting a foreign department of a bank. The next thing would be, why not some of the domestic, perhaps consumer loans, perhaps this, perhaps that.

The next thing you know, you're in regulation of the banks and interest rates by the political part of our economy. I wouldn't be in favor of that. I would say, however, that you have every right to expect that the regulators of the banks look after the interests of the U.S. taxpayer and interests of the U.S. economy in seeing that the banks acted prudently in the amount of money that they loaned to foreign countries.

Senator GORTON. Finally, speaking both to the immediate past when most of these loans took place, into the immediate future, as we place in effect requirements that many banks add to their relatively large loan portfolios, to what extent do you believe that those additional loans, as well as ones in the past, will represent a crowding out of legitimate domestic demand for credit?

Secretary REGAN. Looking at the current loan demand in the United States, I think there are sufficient funds to meet the requirements of our domestic economy. Coming out of a recession as we are, loan demand is naturally down. This means that banks probably have excess funds at this particular time.

I don't think that that situation will last forever. As the economy revs up, actually, loan demand continues to increase. And as a result, automatically I think you'll see the domestic banks cutting back on their foreign loans as this occurs. There will be more domestic demand. They went out seeking these foreign loans when they had excess funds.

Senator GORTON. Let me be a little bit more precise. If, in fact, we do have the kind of recovery for which we all hope, is that not likely to be on a collision course with some of the requirements the IMF may impose on domestic banks to follow up current finance with additional ones?

Secretary REGAN. I don't think so, because, as on one of those charts I showed you, new foreign loans have been falling off rapidly. I think that will probably continue in 1983 and 1984. So I don't think that there will be that crowding out on the domestic side within the foreseeable future.

Senator GORTON. Thank you, Mr. Chairman.

Senator HEINZ. Thank you, Senator Gorton.

Senator Riegle?

Senator RIEGLE. Mr. Secretary, I agree with you that we must take action necessary to maintain the stability of the international monetary structure. I certainly support that premise. I want to be clear, though, on the best action to take, and I want to get into the argument which you advanced earlier. You put a lot of emphasis on exports and jobs. We really ought to look at this as an export opportunity, as a job creator in this country. We're all interested in increased job opportunities, if that's what actually will happen, but there's nothing that requires these countries to spend here in the United States, this additional money that they might borrow through the International Monetary Fund, is there?

Secretary REGAN. No.

Senator RIEGLE. They can spend it however they please. They may spend it in their local economy, they may spend it in traffic with other nations, regardless of what part of it comes back to the United States.

What concerns me is that we have some severe credit needs within our own society. We had a hearing earlier this morning on housing needs in this country, not to mention the Government's borrowing needs. The Government right now is having difficulty even going out and moving quickly in the last few days here—moving through but not as readily as people would like.

So no matter how you couch this, if we go ahead with this proposal to increase funding for the IMF, we're taking credit out of the U.S. system and moving that credit abroad.

GOODS RATHER THAN MONEY

I just wonder, in light of the emphasis that you put on jobs and exports, why wouldn't we be just as well off to propose to these other countries, "Look, if you are desperate for money, we will give you the goods rather than give you the money." In other words, we get a one-for-one shot out of this. "And if you're in desperate shape, and you need an extra billion dollars," whatever the hypothetical figure is, "we will give you that much credit, as long as you buy U.S. goods so to actually employ U.S. workers."

My guess would be that, without requirements, I would be surprised if more than 20 cents on the dollar actually ends up coming back to us by means of exports that we can sell to these countries. I just picked the number out of the air. I don't know what the return is, but I'm certain it's less than half, and I would think it would vary from country to country. Why go through the money exchange first? Why not just say, "Look, whatever it is you need, we'll provide that, and we'll expect to be paid back over a period of time, but we'll supply the goods directly."

Secretary **Regan**. Senator, I'll try to be brief in answering the question, because it is a thoughtful question that deserves a thoughtful answer.

From the point of view of world trade, I think first of all, you have to have an international monetary system, in order to have an international trading system. I think if we were to go back to barter, we will give you our iron ore, and you send us back your rice, or whatever, I think that type of system is unwieldy in the modern era, particularly as we look forward, you know, to additional international trade over the next decade.

I was looking for some figures while you were talking. I think perhaps this illustrates my point. In all countries that are now drawing on the IMF, and that's some 35 to 40 countries that now have IMF programs or are about to have IMF programs, their total imports from the United States were $48 billion. This was 1982. And we imported from them another $51 billion, so there was a total, rounding, of approximately $100 billion in trade with those nations. If we try to do $100 billion worth of trade on a barter basis, it would be much too unwieldy. I don't think we could possibly do it.

Let me illustrate, drawing from the Mexican case, because I use that in one of the charts, as to the falloff of that $8 billion in trade with Mexico, because I think you, coming from Michigan, would be very interested in this. In 1980, we sold Mexico $6.5 billion worth of machinery and transport equipment. In 1981, $8.4 billion. In 1982, about $4.8 billion, a drop there of some $3.6 billion in machinery and transport exports.

Now that—what do we mean? We further broke that down. That's power generation, metal working, industrial, telecommunications. Much emphasis, Senator Lautenberg, on office and data processing, road vehicles and transport. When I say this means jobs, you can see immediately what I'm talking about. Here's $3.5 billion, with just one nation in one specific category, that we missed out on without an IMF program. If the IMF program goes into effect, hopefully, we will get that trade. We can have no assurance that Mexico will buy these goods from us. They might buy them from Germany. They might buy them from France, Japan, what have you. But I think that our exporters are fast enough on their feet, and they're competitive enough so that they'll get their share of this.

Senator **Riegle**. I hear what you are saying. It seems to me there are two problems here. I understand, basically, about 40 cents on a dollar ends up coming back, the other 60 cents on a dollar ends up going somewhere else.

We need jobs at home. It seems to me your taking this block of credit on the margin, that's really what you're doing. You're saying, we want to reserve this additional block of credit and use it for this purpose and not have it available for other purposes, whether or not they be domestic lending purposes here in the United States.

It seems to me you've got two problems. One is the fact that there is no guarantee we'll get jobs back, so why don't we tie it directly to jobs, so that we make sure at a mimimum that we at least get the economic activity that is derived from the use of our own money.

But second, in the case of Mexico and some of the other countries, it is not clear that we are going to be paid back. In other words, we may have the irony here that we're lending them money to buy our goods that they're not going to be able to pay us back in the end, and that's a concern many people have now. In fact, as I understand it, during the recent discussions we've been having with Mexico we've not yet been able to reach a conclusion in terms of their immediate financing problems.

Am I right about that, or is there something more hopeful that has yet to be announced?

MEXICO AND BRAZIL LOAN REPAYMENT PROGRAM

Secretary **Regan**. The Mexican agreement, according to my latest information, they are very hopeful by the end of the month, within less than 2 weeks, that that will be wrapped up and all signed. It is trying to sign up all the banks. I think there are over 500 banks involved in this. They are trying to sign up each and every one of them. The rest of the program has been put in place.

The BIS, the IMF, and the like are in place. It is just the commercial banks. There are a couple of other points that you made that I would like to respond to if I may, whether or not the lending program by the IMF borrowing from us and lending to someone else is going to crowd out credit here in the United States.

I come back to what I said to Senator Proxmire, and that is that in the course of the year this will be in my judgment $1.5 to $2 billion out of a total credit in the United States of some over $600 billion and total borrowings by the U.S. Government, unfortunately, of $240 billion. So I don't think that this additional, commitment if we are called on, will crowd out to that extent.

Senator **Riegle**. I think you make a good point there. As Senator Lautenberg pointed out, the estimates into the future may be off, but could I ask you one other thing, and that relates to the Mexico and Brazil type situations.

When the President traveled to Brazil there was an announcement that we had worked out something on the order of a billion and a half additional credit with them which they desperately needed.

It appears that they now have chewed that up and need more. I mean that wasn't very long ago, as you remember. When you look at situations like Brazil or Mexico in terms of the enormous requirement of money, given the problems that they face, can we continue to meet this base of money demand without carefully considering the question of whether we will ever be paid back?

I think there is real skepticism as to whether or not that money will come back to us. Can we continue to feed those numbers, billions of dollars, into those countries? Even if we want to, do we have the capacity to continue the practice?

Secretary **Regan**. Let me set the record straight on the $1.2 billion, because I was intimately involved in that. That was a temporary loan, a bridging loan, if you will, made to Brazil long before the President went to Brazil—in order to bridge them over until they could accomplish their IMF program and receive their money from the CFF part of the IMF, together with their BIS loans.

Now from that point of view, they have paid back to us now, with interest, $780 million. They have $450 million to go. It is not due as yet in accordance with the terms of the loan. This is very short term, less than 3 months in duration, some becoming due in 30 days, some 60 and the like.

So they have paid back. As to whether or not they need additional funds, yes, Brazil needs additional funds at this point, but they are going to get that from the commercial banks. That is where it is coming from.

They are right now in the process of negotiating financing arrangements and I think the figure—I am recalling this from memory—correct me if I am wrong—is $13 billion in gross financing this year from the banks of which $4.4 billion is not new funds. That will come strictly from commercial banks. That will not come from the Treasury of the United States.

Senator **Riegle**. How much of that $13 billion is from U.S. banks?

Secretary **Regan**. 40 percent is what U.S. banks—of all Brazilian loans 40 percent are U.S. banks.

Senator **Riegle**. Will it stay at the same ratio?

Secretary **Regan**. Yes.

Senator RIEGLE. It is a very important point when looking ahead for the use of credit on margin. You are not only asking for this through government-type agencies; you are also expecting private sector banks to come in with a major additional credit at a time when we have enormous credit needs here in the United States.

I guess that is the dilemma we face. It seems to me, in effect, that you propose it is important for us to put private lending together with quasi-public lending to see what the appetite is for money. It may be that these countries need more money than anybody can provide.

Secretary REGAN. I don't think so. I think that—let's take this, what we were just talking about. They have scaled back quite a bit on their domestic programs. They have scaled back quite a bit on their imports. They will be one of the beneficiaries of the reduction in oil prices since they are such a large importer of energy.

Second, they will benefit most of all nations from any drop in the interest rates. So I think that from Brazil's point of view they will not need these large sums year on year on year, particularly if their own commodity prices recover.

As you know, in the last 30 days commodity prices have turned around, and they seem to be going up. So I would not worry too much about there being a demand for more funds than are available.

Obviously, appetites of nations are large, and they have to be curtailed. Even we face that problem.

Senator RIEGLE. I would like to conclude by saying before you arrived today we had Secretary Pierce, a group of people from the housing industry and regulators from the housing industry to discuss whether or not we can get mortgage interest rates in the 12-percent range, a point at which most people believe will kick off the kind of partial recovery for the overall economy that we need.

But the problem is whether we can get rates down that far. It looks like that may be a sticky problem. What makes it sticky is overspending, and this IMF increase just falls into that category of outside uses of funds, whether they be public or private.

We are walking a very fine line here as we try to tie the domestic economy to the world economy. I think it is fair to ask how much money we can afford to send out of the country.

Secretary REGAN. I think one of the things you have to keep your mind on there is one of the reasons for higher rates of interest in the United States, nominal and real, compared to inflation. One of the worries, and there are many in the money markets, is this international situation, and I think that by nailing down the IMF portion of it, assuring people that there is an international agency that is behind these countries and available for sensible programs is one way to assure the money markets that we won't have an international monetary crisis.

Senator RIEGLE. Thank you, Mr. Chairman.

Senator HEINZ. Senator Riegle, thank you very much.

Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you again. I know that we have a serious problem internationally in the economic markets and also here at home.

IMPACT OF OFF-BUDGET FUNDING FOR IMF

Does the off-budget borrowing of the Federal Government, our budget, our Government, impact the interest rates here at home?

Secretary REGAN. Certainly.

Senator MATTINGLY. Which is—I forget what the amount is—around $20 billion?

Secretary REGAN. That is right.

Senator MATTINGLY. Will the off-budget—what impact do you feel that the off-budget funding of the IMF if we pass through Congress will have on the interest rates?

Secretary REGAN. Little or none, Senator, in my judgment, because, first of all, the amounts over the past few years on average, as I said in my prepared statement, were running below $500 million per year, and that would have a negligible, if any, effect on interest rates.

The last few years it has stepped up. It has been over a billion dollars, but the borrowing of an extra billion by the Federal Government, when it is so bloated anyway, I don't think would have that. The real answer—I hate to get preachy here, but the real answer to that is to cut back on the entire borrowing of the Federal Government, both on and off budget. That will do more for interest rates than this IMF.

Senator MATTINGLY. I agree with that. Now I forget who said—he asked about the worst case scenario that may happen in the borrowing. It may have been $500 million in the past or $1 billion or $2 billion, but obviously it could be greater than that, with the impacts of the financial crisis that is going on.

All I am saying is what would be the impact if they had to have $3 billion. Now would that fact impact ——

Secretary REGAN. Are you talking about 1983 or 1984?

Senator MATTINGLY. I would say within the next 12 months. What impact historically would we look at of off-budget borrowing on interest rates?

Secretary REGAN. It would have some impact, but again it would be minor compared to other things, such as total borrowings, monetary policy, and the like. They have a lot more effect on the rates of interest than that amount of off-budget financing.

Senator MATTINGLY. Then you say it wouldn't have any effect?

Secretary REGAN. I didn't say any. I said negligible.

Senator MATTINGLY. Is that half a point?

Secretary REGAN. I don't think I could quantify it frankly.

Senator MATTINGLY. What impact does, say, the $20 billion have on off-budget borrowing?

Secretary REGAN. Again, this is just a judgment factor, but there has to be a quarter or a half a point for people borrowing that much less and people knew that that was going to be conditioned year on year. Interest rates would be coming down.

Senator MATTINGLY. When it grants a loan, the IMF insists on certain conditionalities—I know we covered part of this—insist on certain conditionalities, using a form of economic targets that mandate austerity for the borrower that would otherwise be politically unpopular.

TOOL OF CONDITIONALITY

Could the United States use the tool of conditionality? I believe you originally testified that their resources are so thin, these borrowing countries, that probably they just wouldn't be applicable to them, but could the tool of conditionality to reduce the trade barriers which American exports face plus knowing full well that some of them use the moneys from their country to use to help subsidize their exports—in other words, would you be willing, or what do you think the tool of conditionality could be used to reduce the trade barriers which American exports face in the international trade market?

Secretary **Regan**. This can be discussed with the member countries who are borrowing from the IMF, but I think literally most of our problems with subsidies and with trade barriers are coming from the industrialized countries rather than from the less developed countries.

We all know the problems that we are having currently with Japan, some problems we are having with the EEC nations, things of that nature. Those problems, of course, would not apply here in the IMF at present.

Senator **Mattingly**. Let me just throw in one. Let's see if you can answer it as you go along here. You mentioned about Brazil having scaled back its imports, yet we know they subsidize their exports heavily.

Secretary **Regan**. Well, here you are sort of on the horns of a dilemma. You have these nations that are trying to grow. As they try to grow, the industries that they are trying to find that are labor intensive are usually industries that have terrific competition in the international markets. They try to subsidize in order to provide jobs.

That is not unique, of course, to Brazil or to these other developing countries, because most of the developed countries do the same thing.

From the point of view of advocating that they have freedom of trade and the like, there usually is a clause put in that cautions the borrowing nation from imposing new barriers to imports. But it is very difficult for the IMF to go in and tell a country it can not do this or that when the other members of the IMF are already doing it to them.

Senator **Mattingly**. I don't want to put you on the spot, because I think you do an outstanding job as Treasury Secretary, but on conditionalities I think we are going to be faced, if this Congress tends to pass legislation to strengthen the conditionalities of these loans, and I know it is a continuous situation, to say the least.

But when you get into subsidized exports or trade barriers, it would seem as if maybe this might be an appropriate time to try to strengthen the hand of the free traders of the world, whether it be us, Australia, no matter who it is, so they can play on a level playing field.

If we are going to give money—not to give, but put money into the IMF, we would like to try to preclude them—whoever gets it—from using it as a subsidy. I think it is only fair that the American taxpayer may expect that to be written into this legislation when it comes up.

Secretary REGAN. Senator, may I offer this for the record? There is a standard performance criterion for IMF programs, and that prohibits new or intensified restrictions on payments for current transactions. The provision typically states the country may not make purchases under an arrangement if it imposes new or intensifies existing restrictions on payments and transfers for current international transaction, or introduces or modifies multiple currency practices, or concludes bilateral payments agreements which are inconsistent with article 8, or imposes or intensifies import restrictions for balance of payments reasons.

So the IMF already has this written in. It is a question of how to carry out that antiprotectionism type of provision.

Senator MATTINGLY. I understand that Brazil, as an example, had a poultry contract with Iran for $153 million, which they subsidized very heavily in the last 6 months. All I am saying, you know, a country that owes $80-some odd billion somewhere along the line they are getting some money somewhere to subsidize the contracts.

All I am saying—not necessarily that country, but any other country—I am just saying I feel we ought to strengthen those conditionalities, and I know that you have the conditions already written in.

But obviously, some of the countries don't understand them, and I am just saying maybe we ought to make them a little bit more obvious.

Senator RIEGLE. Would the Senator yield on that point for a minute?

Senator MATTINGLY. Just for a second. I have got a followup for him.

Senator RIEGLE. What you mentioned was prohibiting money that would be used to subsidize block imports, not to do what Senator Mattingly is talking about. That is to subsidize exports.

Perhaps I missed it. I didn't hear exports mentioned in that same frame of reference.

Secretary REGAN. The interpretation I would put on this would be that it applies to payments for imports and exports.

Senator RIEGLE. Perhaps we need to make that clear.

Secretary REGAN. Let's just not use the word export.

Senator MATTINGLY. Also according to my advisers, also prospective. In other words, it would not apply to the contracts that are current, or trade arrangements that are currently made.

So maybe they ought to be made retroactive. It's just a thought.

Secretary REGAN. I don't think you can make it retroactive, because the countries are now under this program. Both they and the IMF have signed up to this agreement. I think that we could do our best to make sure that we've inserted more precise language in the future.

Senator MATTINGLY. It would help. Let me ask you one other question here.

But knowing full well we've got evolutionary economic change, not just in this country, but all over the world, would it be better, possibly, to address this problem with the IMF funding after we hold an economic summit so that maybe we can have a little bit greater clarification of the problems?

I don't think we're talking about a very long time away, either.

Secretary Regan. I suspect, Senator, that action by this Congress probably will not happen until after the summit, if I know what the current schedule in the Congress is.

I'm not sure just how fast this could come up for a vote. But, the summit is the end of May. I would suspect on any kind of a calendar, this would probably come up after May, anyway.

But I don't know of anything at this moment that would happen at the summit that would in any way negate our support for an increase in the IMF quota.

Senator Mattingly. My time has expired. I would go along with my chairman and several others that want to really look at the conditionalities, especially with respect to trade in this country.

Thank you very much.

Senator Heinz. Mr. Secretary, before I yield to Senator Bradley, who has been very patient and understanding, if he is still awake; let me just congratulate the Senator on his contribution and state that I would welcome any initiatives; be willing to work with him to develop an effective means of trying to improve conditionality so it does stabilize world trading patterns in a way that will enhance the free trading system that we would all like to see.

Senator Bradley, I apologize that you have had to wait so long. You've been here a long time. Those are the risks you take when you're not a member of a committee.

But let me say because I think Senator Bradley is probably too modest to say it for himself——

Senator Bradley. Don't say that, Mr. Chairman.

Senator Heinz. Methinks he doth protest too much.

Senator Bradley is very knowledgeable about international banking matters. I understand when he was a member of the Knicks, rather than playing cards, watching television, or putting on weight, which he has done since, that he has spent a good deal of his time studying international banking.

And with that introduction to his expertise, Senator Bradley——

Senator Bradley. I hope that doesn't intimidate you. [Laughter.]

Senator Heinz. The Senator is from New Jersey.

STATEMENT OF SENATOR BILL BRADLEY

Senator Bradley. Mr. Chairman, I thank you very much for giving me the opportunity to come to this committee today to ask a few questions.

COVERING POTENTIAL LOAN LOSSES

Mr. Secretary, on page 11 of your testimony, you say, and I quote:

> When interest payments are more than 90 days late, not only are bank profits reduced by the lost interest income, but they may also have to begin setting aside precautionary reserves to cover potential loan losses.
>
> If the situation persisted long enough, the capital of some banks might be reduced.

My question to you is: Are you saying that in order to avert a threat to the capital structure of our banks, we need to increase quotas to the IMF?

Secretary REGAN. Not directly, Senator, no. What I'm saying here is that there is a condition existing in the world in which there are many nations whose loans are in a precarious situation with danger of being substandard loans.

If that happens, the bank has to take it on the chin. Depending upon the extent of time, and amount, whether this obviously will hit first in the earnings and second in the surplus, maybe later in the capital.

From that point of view, it will have an effect there. But I am not pleading for this loan or this increase in the quotas in order to bail out the banks.

Far from it.

Senator BRADLEY. So that you had a sequence of things. If there is a nonperforming loan, it is written off against what and what, and then capital?

Secretary REGAN. Obviously, earnings first. Any earnings that have accumulated throughout the year, or might accumulate the rest of the year.

Second, through surplus—first to reserves, then to surplus, and then later to capital.

Senator BRADLEY. Then to capital. Do you think that—let's say in the next paragraph, you describe capital asset ratio, what that means.

Do you think that a higher capital asset ratio is better than a lower capital asset ratio in the present climate?

Secretary REGAN. I think in the present climate the banks would probably be becoming much more conservative, cutting their ratio back.

Senator BRADLEY. Do you think this committee should be concerned about capital asset ratios?

Secretary REGAN. I think this is something you would want to discuss with the chairman of the Federal Reserve bank and the other bank regulators.

I think this is the Fed's prerogative of the regulators. This is where the Congress has put that power, and I think it is something you do want to discuss with them.

Senator BRADLEY. You said you felt generally you had a 16-percent capitalized set ratio? It's a little more stable in this environment than the 3 percent or 2 percent.

In general terms, that's what I think you said.

Secretary REGAN. Obviously the better the ratio from the point of view, what is the ratio of your capital to your assets the better off the bank——

Senator BRADLEY. The more stable the bank is, and the more stable the system.

OK. My next question is the information that we get about what is the crisis, and this came to a head with the Mexican situation, is how current is that information?

Secretary REGAN. The Mexican information——

Senator **Bradley**. No. When we ask for an analysis to be given to the committee, as what is the exposure of banks internationally to Brazil or to Argentina, how current is that information?

Secretary **Regan**. Mid-June is the latest information. That would be current.

Senator **Bradley**. Mid-June.

Secretary **Regan**. There will be more information available toward the middle of the year.

Senator **Bradley**. My concern, and I was wondering—the reason I raised this is because the committee will be discussing it.

But if the information is not current, and I'm told that by the time all the banks in the United States get their information to the central bank, that it takes 4 to 6 months, and there is 2 to 3 months more for when the BIS coordinates the information, disseminates it in the report, so that if you were looking at that kind of data, you are 9 months out of date.

And I wondered if you don't think that in the age of computer technology, we couldn't improve on that?

Secretary **Regan**. You can definitely improve on that. It's been remarkable. We had to go looking for the information for Mexico or for Brazil, and ask all the banks to report. We got the information in much less time than 9 months, I can assure you of that. And you are right, there are better ways of collecting this information. But to whom it should be disseminated and the like is a separate question.

RESPONSIBILITIES OF OVERSEAS SUBSIDIARIES

Senator **Bradley**. OK. The next question. Are you concerned at all about the whole area of who has responsibility for the bank on the Grand Cayman Islands in the event that that bank had a crisis of liquidity; and have you resolved in your own mind who is responsible in the wake of the Banco Ambrosiano problem of last year?

Secretary **Regan**. No, I have not resolved it in my own mind, and it's still an open question as to who has responsibility in these tax havens for many of these banks that are operating there.

Senator **Bradley**. You think we should try to answer that question? Or do you think that this would be providing too great an insurance to banks?

Secretary **Regan**. I think it's something we should come to grips with. Is there indeed a bank of last resort, or should there be a bank of last resort for all Eurodollars?

Senator **Bradley**. What is your view?

Secretary **Regan**. I don't think there should be. I think that if a bank operates in that market, it should bear the related risk—both our banks and non-U.S. banks.

I don't think the U.S. taxpayer should be asked to stand behind anything of that nature.

Senator **Bradley**. Isn't that contrary to the 1974-75 Central Bankers' agreement that you'll take responsibility for your own overseas subsidiaries?

Secretary **REGAN**. Yes, your overseas subsidiaries. But most of the banks operating in those areas are not subsidiaries of American banks. Some are, but not all.

Senator **BRADLEY**. So you would be in favor of the Federal Reserve taking responsibility for overseas subsidiaries?

Secretary **REGAN**. The branches of American banks, yes.

Senator **BRADLEY**. But only those, and therefore, only Germans take responsibility for German overseas subsidiaries?

Secretary **REGAN**. Yes, that's my thought. The Germans take responsibility for the branches of their banks.

Senator **BRADLEY**. Let me ask you another question. You talked about how in the last year we have lost $3½ billion worth of trade with Mexico.

Secretary **REGAN**. The total figure is an $8 billion swing in our position. The $3½ billion was in reduced machinery and transport equipment exports.

Senator **BRADLEY**. Okay. What in addition to an IMF quota increase, do you think is necessary in order to have some sense that we'll get that trade back?

Secretary **REGAN**. Obviously, it has to be that Mexico will recover from its current condition.

Senator **BRADLEY**. Coordinated economic recovery?

Secretary **REGAN**. Definitely.

Senator **BRADLEY**. I was pleased to see Mr. Sprinkle make the statement during your recent visit to our allies that he was all for that.

Did you encourage him to make that statement?

Secretary **REGAN**. I made it first. He made it second. [Laughter.]

Senator **BRADLEY**. One further question, and that is you know we are kind of going through a period of transition, as you are well aware, in deregulation of financial institutions.

And we are also in the third year of an atmosphere in Washington that has been intentionally stated as antiregulation.

What I wonder is do you think that that attitude at all contributed to the failure to catch these loans in the last 2 years, that were piling up on the books of banks?

Secretary **REGAN**. No, I don't think so, Senator. I think that they are two entirely separate things. The area of deregulation has not been in this international area at all.

No one has suggested deregulation in that area.

Senator **BRADLEY**. Do you think that the Federal Reserve should perform the role of the central bank aggressively, as a regulator?

Secretary **REGAN**. Frankly, I thought they had been, Senator. But I agree with you. Yes, it should.

Senator **BRADLEY**. Getting back to the first question. Do you think that the Federal Reserve should aggressively try to shore up the capital structure of our banks today?

Secretary **REGAN**. I don't think they should do it themselves, but I think they should encourage the banks to do it.

Senator **BRADLEY**. So they should use whatever tools they have now to do that?

Secretary **REGAN**. I think most banks are acutely aware of this at this point, and are trying their best to do it.

POTENTIAL INCREASE OF EMPLOYMENT

Senator **Bradley**. One final question. You said you think the increase in quotas will produce how many jobs? Lets make sure we have it on the table, because it's a very important issue.

Secretary **Regan**. I didn't specifically put a number of jobs together with this IMF quota. What I'm saying is that this quota will keep in being, and help to foster where it has slipped, our export business, where the LDC's are able to import from the United States various types of products, either agricultural or manufactured.

And to the extent that they don't have financing, as was the case with Mexico, which I used as the illustration, a drop of $8 billion in our trade balance, mainly in exports, certainly should mean some type of job loss.

It's not quantified exactly how many jobs could be associated with the quota increase, but certainly there should be some.

Senator **Bradley**. I thought you had a number in your testimony. I'm not positive.

Secretary **Regan**. The figure that I used was on a chart, 24,000 jobs per billion dollars of exports. It's what most economists use as a figure.

So that if we have $200 billion of exports, 200 times 24,000.

Senator **Bradley**. So if indeed we did not increase the quota, and that led to a further downturn in the economies of Mexico or Brazil, that would have in your view direct effect on jobs in this country, by decreasing those jobs?

Is that not correct?

Secretary **Regan**. In general, yes. But let me specifically say that we don't feel that there is a need for any part of this increased quota from Mexico or Brazil. They already have their IMF programs. These additional resources will be for other nations that might be getting into trouble.

Senator **Bradley**. One last question. And that is, could you tell me, we're talking about this year, extending a billion dollars.

Given the size of the outstanding debt and the exposure of the banks, and the timetable, which is really the next year or the next 2 years, as to whether we're going to have economic recovery; do you think that's really sufficient?

Secretary **Regan**. This is up to the IMF as to how much money and where it draws the money from. My indications are that the IMF has about 28 billion SDR's on which it can draw in usable currencies. That's even less when you get down through their various commitments, so that there is about 10 billion SDR's, or about the equivalent of $11 billion of funds available for further IMF programs at this point.

They can call on us for a portion of that, and our assumption is it would be about $1 billion in cash annually.

Senator **Bradley**. Based upon these questions, then, I would conclude that yes, you do think that we ought to get better information sooner?

Secretary **Regan**. Yes.

Senator **BRADLEY**. But no, you don't consider the general regulatory environment to have any responsibility for the present problem with the banks?

Secretary **REGAN**. In general, yes.

Senator **BRADLEY**. You think the Federal Reserve should exercise whatever powers it could and as it is doing now to shore up the capital structures of banks?

Secretary **REGAN**. Yes.

Senator **BRADLEY**. You think the coordinated response is important, and that you want to look at the lender of last resort; but you don't think a central bank should take responsibility for anybody's overseas subsidiaries?

Secretary **REGAN**. That's right—not anybody else's branches.

Senator **BRADLEY**. Thank you.

Senator **HEINZ**. Mr. Secretary, I understand Senator Proxmire has one or two very brief questions. I have one brief question. I know you've got to go.

My brief question is simply this: given the fact that a very significant amount of the exposure of U.S. banks is concentrated among our nine largest banks, who have about $60 billion of a total $100 billion exposure to LDC's here; about half of that exposure is just to three countries, Argentina, Brazil, and Mexico.

Given the fact that that $60 billion exposure amounts to roughly 200 percent of their capital and taking into account your responses to Senator Bradley's question, are you saying that you believe the Federal Reserve should adopt or be encouraged to adopt a set of specific mandates or policies that would in fact have the effect of increasing the capital to asset reserves of banks that are significantly exposed?

Secretary **REGAN**. I didn't say that I would specifically suggest that the bank regulations mandate that.

I said that in essence, rather I thought they should be encouraging banks to increase their capital in relation to their assets.

Indeed, I think the banks themselves are trying to do that. I think that's, again, a question that you should put——

Senator **HEINZ**. So you would make a distinction between mandate and encourage? That is the essential difference?

Secretary **REGAN**. Yes.

Senator **HEINZ**. Thank you.

Senator Proxmire?

Senator **PROXMIRE**. Mr. Secretary, I'll be as brief as I can. I think the impression has been given that we're a borrower—I don't think you give that impression, necessarily, but some people have assumed after all, we provide these funds to the IMF, we borrow them back ourselves, we use them for our own purposes.

But I think we should make very clear that that borrowing is an entirely different kind of borrowing than the underdeveloped countries are interested in.

No. 1 in your annex B, page 2, you provide three principal purposes. One is to reduce the outflow of gold. Two is for swap purposes. And three is also an outflow of gold problem. As far as swaps were concerned, there are other ways we can do that.

We have the IMF—this is more convenient. This is more efficient.

Secretary REGAN. The exchange stabilization fund could be used for swaps.

Senator PROXMIRE. Yes, that's right. As far as the gold alternatives are concerned, that's quite different of course than the borrowing from these other countries.

In no case, as I understand it, have we exceeded our quota in borrowing. In no case have we had therefore to pay interest. In no case are we, therefore, in the position that these underdeveloped countries are.

Is that right?

Secretary REGAN. That's right. The word I used, Senator, was user of IMF resources. We have never technically borrowed from the IMF.

We have drawn down our own reserves, and we don't have to pay those back.

Senator PROXMIRE. Also, I'm concerned, as many are, about the possibility we always have to be concerned about that the situation can get worse.

International situation could continue bad, our economy could continue bad, and so forth. I think that's one thing banks ought to be prepared for.

BORROWING FROM THE WORLD BANK

Now, if more is required of international lending, it seems to me the World Bank might be a possibility.

We had a prominent banker testifying before the Foreign Relations Committee about it 2 weeks ago, in which he suggested we double our contribution to the World Bank.

Is there a likelihood that we're going to be asked to do that in the next year or two, in your judgment?

Secretary REGAN. First of all, Senator, I would not want the World Bank to get into the same business as the IMF.

Senator PROXMIRE. I understand it's quite different.

Secretary REGAN. They're entirely different. As far as the World Bank's resources, we will be and have suggested a supplemental request in fiscal year 1983 for IDA, the soft loan window of the World Bank.

We asked—we got $700 million from the 1983 continuing resolution. We're back in for a supplemental of $245 million. In the 1984 budget we are in for a $1.95 million.

Those are the only two requests we have currently in for the World Bank's soft loan window.

Senator PROXMIRE. Don't we have a situation in the World in which this long-term money is needed, not for necessarily balance of payments purposes, but because the economy of some of these countries are in serious difficulties?

Doesn't the World Bank provide that long-term money rather than short-term kind of——

Secretary REGAN. For development projects, yes. That's exactly what the World Bank was set up for, infrastructure and other types of loans of that nature.

We think the World Bank has enough in the hard loan window, with the current general capital increase, to which will be contributing through fiscal year 1987. We're encouraging them to go joint with the private sector and the IFC window of the World Bank.

We think if they were to put up let's say 10 or 25 percent of a particular project, that private lenders would put up the balance with them, provided that the World Bank is also pari passu on the note.

Senator PROXMIRE. Do you or do you not foresee the World Bank needing more replenishment from the United——

Secretary REGAN. Only United——

Senator PROXMIRE. That could amount to what, $5 or $10 million?

Secretary REGAN. In the supplemental request plus our fiscal year 1984 request our portion would be something in the neighborhood of $1.3 billion or $1.4 billion for the soft loan window and $110 million a year for the hard loan window.

And the rest of the world would be putting up—we're about 25 or 26 percent in the World Bank.

So three times what we put up.

Senator PROXMIRE. Finally, isn't the most likely conditionality that the IMF would propose that a country improve its balance of payments situation by reducing its imports?

Secretary REGAN. Not necessarily.

Senator PROXMIRE. For one thing, they could control—it would be better if they could control it.

Secretary REGAN. What they could encourage them to do is to have a more austere program. And taking in imports, if indeed the country has been taking in too many imports, it would be one of the suggestions.

But that is not necessarily a part of every IMF program, and certainly not the longer term objective.

Senator PROXMIRE. I understand a situation like Mexico or any other trading partner for this country, that's important. That could be perverse as far as our economy is concerned.

I'm not saying is that right or necessary, but I'm saying we have to have our eyes open.

Secretary REGAN. There's no doubt if every nation in the world would cutdown on its imports, that would certainly hurt the U.S. economy.

Senator PROXMIRE. Or just the nations dealing with the IMF.

Thank you very much, Mr. Regan.

Senator RIEGLE. Just very quickly, two things. First, Mr. Chairman, I think it would be helpful if we could get the committee staff figures through the end of the year on American bank lending abroad, so our statistics are not 6 months out of date.

I would think because most of these loans are by very identifiable banks, we ought to be able by means of a simple phone call to get current data on outstanding loans so that we can understand the magnitude of the private commitments.

We might even be able to get data, through the end of January, at least from the major banks that we are familiar with.

I'd like to encourage that we be more up to date than the middle of last year, and I think we can be.

Senator HEINZ. Hopefully when Chairman Volcker appears tomorrow, he'll be able to be more current.

SURPLUS FUNDS TO FOREIGN LOANS

Senator RIEGLE. The other point is, earlier, Mr. Secretary, you made the comment in passing that domestic banks have made many of these foreign loans because they had surplus funds at the time.

Nobody stopped you at that point. But I think if we're going to be honest about it, the fact of the matter is they are able to get a higher interest rate off the foreign loans, regardless of the quality of those loans. And now they are wondering if they are ever going to be paid back.

But, they were getting higher interest rates. There were plenty of people in this country here willing to borrow, had they been able to get their hands on the money at perhaps a somewhat lower interest rate.

I know there are a lot of businesses large and small in need of affordable finances, and people who wanted to buy homes, people who wanted to buy cars, and so forth.

So I think it's important to note that it was not because we were sitting here with a lot of surplus money in the United States that nobody wanted.

In fact, the banks were after higher interest rates, weren't they?

Secretary REGAN. I would assume the banks are profit motivated, and higher rates of interest is probably what motivated them.

What I was referring to, though, when I said surplus funds, I was referring to the OPEC problem of intermediation where part of the world's wealth was flowing from the oil importing countries to the OPEC countries, and then circulating it back again through the medium of the bank as loans to those very same countries.

Senator RIEGLE. We also had some of our domestic savings going out of the country, didn't we?

Secretary REGAN. Since funds are fungible, it would be hard to trace that. But as to how much came in from OPEC, and how much went out——

Senator RIEGLE. Wouldn't it be in the interest of a less developed country that was in trouble to offer higher interest rates in order to keep the credit coming?

Wouldn't it be better for them to outbid the domestic borrowers here in the United States who might be more prudent or unable to afford to pay as high a rate?

In other words, if a foreign country is willing to pay a 15 percent rate, and a domestic borrower here in the United States only feels they can pay 12, the banks, following their profit motive, go abroad with the loan. Doesn't that foreign country always have the incentive to bid up the price of the available credit to keep the credit coming to them rather than to somebody else?

Secretary REGAN. Ordinarily, sovereign loans are at a lower rate than an ordinary corporate borrower. A corporate borrower who is an A or a BBB creditor would certainly pay more for his money, that is pay a higher rate of interest than a sovereign nation.

Senator RIEGLE. Is that true of Brazil, say, versus AT&T?

Secretary REGAN. AT&T has of course an AAA credit. But sovereign nations, depending upon the nation, obviously usually can command a lower rate of interest, because they have the power to tax, than can a corporation or an individual.

Senator RIEGLE. Are you saying that domestic banks actually took lower rates of return for some of these foreign loans?

Secretary REGAN. Again, depending upon which nation. Take a Scandinavian nation or France, or Great Britain, something of that nature—the rates of interest would be lower.

Senator RIEGLE. I'm thinking of those that are in trouble, where they want additional credit.

Senator HEINZ. Mr. Secretary, on that point, if the Senator will yield. What proportion of the loans to LDC's from U.S. banks were to governments, and what proportion were to corporations, businesses, subsidiaries?

Secretary REGAN. I think it's on the order of 40 to sovereign governments, including some credit on loan from the banks, and 60 percent to private credits, within those same nations.

Senator HEINZ. In the LDC's?

Secretary REGAN. Yes.

Senator HEINZ. Mr. Secretary, you've made an extraordinarily persuasive case. You've done an extraordinarily good job representing the U.S. position.

You've come back with an agreement that has been hard and well bargained.

I think it should be obvious to anybody who was present and who will read the record that the members of the committee are not only impressed with what you have brought back from the interim committee, not only been impressed with your presentation; but there is, I would say, general and broad support for the basic principles you have come here to advocate and defend.

It is also equally clear that notwithstanding the support for the basic principles of the increase in the IMF quota and the GAB, that there are committee members, maybe most of them, who are very concerned about taking steps to prevent to the extent possible to human beings, any recurrence of the kind of overextension of credit which wittingly or unwittingly through imprudence, greed or bad luck the financial institutions in this, joined by other countries, have indeed participated in.

And there is an equal interest in seeing to it that the conditionality of the International Monetary Fund, and I would assume any use of the General Agreement to Borrow would emphasize much more strongly than heretofore in the fine print or specs of the IMF conditionality principles, much more attention to the observance of the principles of free trade by which we take to mean decreasing reliance on export subsidies, decreasing emphasis on artificial barriers to trade, particularly nontariff barriers as well as tariff barriers to imports.

Concomitantly, I suppose, a little bit more increased reliance on the classical means of addressing trade imbalances. Namely, readjustment of currency valuations.

We are going to have more hearings tomorrow and the rest of the week to proceed to develop methods of developing the latter two kinds of problems.

Let me just say that your testimony in all regards has been responsive and extremely valuable.

Thank you for your time.

Secretary REGAN. Thank you, Mr. Chairman.

[Whereupon, at 4:50 p.m., the hearing was adjourned.]

[The complete statement and response to written questions of Senator Heinz follow:]

STATEMENT OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
Washington, D.C.
February 14, 1983

IMF Resources, World Financial Stability, and U.S. Interests

Mr. Chairman and members of the Committee:

It is a pleasure to appear before you today to explain and support the Administration's proposals for legislation to increase the resources of the International Monetary Fund.

After extensive consultations and negotiations among IMF members, agreement was completed last Friday on complementary measures to increase IMF resources: an increase in quotas, the IMF's basic source of financing; and an expansion of the IMF's General Arrangements to Borrow (GAB), for lending to the IMF on a contingency basis, if needed to deal with threats to the international monetary system. These must now be confirmed by member governments, involving Congressional authorization and appropriation in our case, in order to become effective. As background to our legislative proposals, which we will submit formally within a very few days, I would like to outline the problems facing the international financial system, the importance to the United States of an orderly resolution of those problems, and the key role the IMF must play in solving them.

The International Financial Problem

Since about the middle of last year, the international monetary system has been confronted with serious financial problems. The debt and liquidity problems of Argentina, Brazil, Mexico, and a growing list of other borrowers became front-page news -- and correctly so, since management of these problems is critical to our economic interests. Bluntly stated, the problem is that the debts of many key countries became too large for them to continue to manage under present policies and world economic circumstances; lenders began to retrench sharply; and the borrowers have been finding it difficult if not impossible to scrape together the money to meet upcoming debt payments and to pay for essential imports. As a result, the international financial and economic system is experiencing strains that are without precedent in the postwar era and which threaten to derail world economic recovery.

There is a natural tendency under such circumstance for financial contraction and protectionism -- reactions that were the very seeds of the depression of the 1930s. It was in response to those tendencies that the International Monetary Fund was created in 1944, largely at the initiative of the U.S. government, to offer a backstop and underlying support mechanism to prevent a recurrence of that slide into depression. If the IMF is to be able to continue in that role, it must have adequate resources to deal with the current situation.

The current problem did not arise overnight, but rather stems from the economic environment and policies pursued over the last two decades. Inflationary pressures began mounting during the 1960's, and were aggravated by the commodity boom of the early 1970's and the two oil shocks that followed. For most industrialized countries, the oil shocks led to a surge of imported inflation, worsening the already growing inflationary pressures; to large transfers of real income and wealth to oil exporting countries; and to deterioration of current account balances. For the oil-importing less developed countries -- the LDCs -- this same process was further compounded by their loss of export earnings when the commodity boom ended.

For both industrial and developing countries, the appropriate policy response to all these events would have been a combination of fiscal and monetary restraint to resist inflationary pressure, and willingness to let structural adjustments take place to adapt their economies to the higher relative price of energy. The higher energy price made many industries less competitive, and adjustment required that resources be shifted away from them. Similarly, the transfer of real income and wealth to OPEC implied a reduction in real income at home.

Instead, most governments tried to maintain real incomes through stimulative economic policies, and to protect jobs in uncompetitive industries through controls and subsidies. Inflationary policies did bring a short-run boost to real growth at times, but in the longer run they led to higher inflation, declining investment and productivity, and worsening prospects for real growth and employment.

Similarly, while these policies delayed economic adjustment somewhat, they could not put it off forever. In the meanwhile, the size of the adjustment needed was getting larger. Important regions remained dependent on industries whose competitive position was declining; inflation rates and budget deficits soared; and --

most pertinent to today's financial problems -- many oil importing countries experienced persistent, large current account deficits and unprecedented external borrowing requirements.

In the inflationary environment of the 1970's, it was fairly easy for most nations to borrow abroad, even in such large amounts. Commercial banks were "recycling" surplus OPEC funds; interest rates were low in relation to current and expected inflation; and both borrowers and lenders expected that continued inflation would lead to ever-increasing export revenues and reduce the real burden of foreign debts. As a result, many countries' foreign debts continued to grow too rapidly for too many years.

Most of the increased foreign debt reflected borrowing from commercial banks in industrial countries. By mid-1982, the total foreign debt of non-OPEC developing countries was something over $500 billion -- more than five times the level of 1973. Of that total, roughly $270 billion was owed to commercial banks in the industrial countries, and more than half of that was owed by only three Latin American countries -- Argentina, Brazil, and Mexico. New net lending to non-OPEC LDCs by banks in the industrial countries grew at a rising pace -- about $37 billion in 1979, $43 billion in 1980, and $47 billion in 1981 -- with most of the increase continuing to go to Latin America. (See Charts A and B.)

That there has been inadequate adjustment and excessive borrowing has become painfully clear in the current economic environment -- one of stagnating world trade, disinflation, declining commodity prices, and interest rates which are still high by historical standards. Over the past two years, there has been a strong shift to anti-inflationary policies in most industrial countries, and this shift has had a major impact on market attitudes. Market participants are beginning to recognize that our governments intend to keep inflation under control in the future and are adjusting their behavior accordingly.

In most important respects, the impact of this change has been positive. Falling inflation expectations have led to major declines in interest rates. There has been a significant drop in the cost of imported oil. On the financial side, there is a shift toward greater scrutiny of foreign lending which may be positive for the longer run, even though there are short-term strains. Lenders are re-evaluating loan portfolios established under quite different expectations about future inflation. Levels of debt that were once expected to decline in real terms because of continued inflation -- and therefore to remain easy for borrowers to manage -- are now seen to be high in real terms and not so manageable in a disinflationary world. As a result, banks have become more cautious in their lending -- not just to LDCs but to domestic corporations as well.

There is certainly nothing wrong with greater exercise of prudence and caution on the part of commercial banks -- far from it. Since banks have to live with the consequences of their decisions, sound lending judgment is crucial. In addition, greater scrutiny by lenders puts pressure on borrowers to improve their capacity to repay, and creates an additional incentive for borrowing countries to undertake needed adjustment measures.

But a serious short-run problem has arisen as a result of the size of the debt of several key countries, the turn in the world economic environment, inadequacy of adjustment policies, and the speed with which countries' access to external financing has been cut back. Last year, net new bank lending to oil importing LDCs dropped by roughly half, to something in the range of $20 to $25 billion for the year as a whole (Chart B), and came to a virtual standstill for a time at mid-year. This forced LDCs to try to cut back their trade and current account deficits sharply to match the reduced amount of available external financing.

The question is one of the speed and degree of adjustment. While the developing countries must adjust their economies to reduce the pace of external borrowing and maintain their capacity to service debt, there is a limit, in both economic and political terms, to the speed with which major adjustments can be made. Effective and orderly adjustment takes time, and attempts to push it too rapidly can be destabilizing.

The only fast way for these countries to reduce significantly their deficits in the face of an abrupt cutback in financing is to cut imports drastically, either by sharply depressing their economies to reduce demand or by restricting imports directly. Both of these are damaging to the borrowing countries, politically and socially disruptive, and painful to industrial economies like the United States -- because almost all of the reduction in LDC imports must come at the direct expense of exports from industrial countries. They are exactly the sort of reaction that the IMF was created to avoid. But as the situation has developed in recent months, there has been a danger that lenders might move so far in the direction of caution that they compound the severe adjustment and liquidity problems already faced by major borrowers, and even push other countries which are now in reasonably decent shape into serious financing problems as well.

Importance to the United States of an Orderly Resolution

It is right for American citizens to ask why they and their government need be concerned about the international debt problem. Why should we worry if some foreign borrowers get cut off from bank loans? And why should we worry if banks lose money? Nobody forced them to lend, and they should live with the consequences of their own decisions like any other business.

If all the U.S. government had in mind was throwing money at the borrowers and their lenders, it would be difficult to justify using U.S. funds on any efforts to resolve the debt crisis, especially at a time of domestic spending adjustment.

But of course, there is more to the problem, and to the solution. First, a further abrupt and large-scale contraction of LDC imports would do major damage to the U.S. economy. Second, if the situation were handled badly, the difficulties facing LDC borrowers might come to appear so hopeless that they would be tempted to take desperate steps to try to escape. The present situation is manageable. But a downward spiral of world trade and billions of dollars in simultaneous loan losses would pose a fundamental threat to the international economic system, and to the American economy as well.

In order to appreciate fully the potential impact on the U.S. economy of rapid cutbacks in LDC imports, it is useful to look at how important international trade has become to us. Trade was the fastest growing part of the world economy in the last decade -- but the volume of U.S. exports grew even faster in the last part of the 1970's, more than twice as fast as the volume of total world exports. By 1980, nearly 20 percent of total U.S. production of goods was being exported, up from 9 percent in 1970, although the proportion has fallen slightly since then. (Charts C and D.)

Among the most important export sectors for this country are agriculture, services, high technology, crude materials and fuels. American agriculture is heavily export-oriented: one in three acres of U.S. agricultural land, and 40 percent of agricultural production, go to exports. This is one sector in which we run a consistent trade surplus, a surplus that grew from $1.6 billion in 1970 to over $24 billion in 1980. (Chart E.)

Services trade -- for example, shipping, tourism, earnings on foreign direct investment and lending -- is another big U.S. growth area. The U.S. surplus on services trade grew from $3 billion in 1970 to $34 billion in 1980, and has widened further since. (Chart F.) When both goods and services are combined, it is estimated that one-third of U.S. corporate profits derive from international activities.

High technology manufactured goods are a leading edge of the American economy, and not surprisingly exports of these goods have grown in importance. They rose from $7.6 billion in 1970 to $40 billion in 1980. And even in a sector we do not always think of as dynamic -- crude materials and non-petroleum fuels like coal -- exports rose six-fold, from $2.4 billion to $14.6 billion over the same period.

Vigorous expansion of our export sectors has become critical to employment in the United States. (Chart G.) The absolute importance of exports is large enough -- they accounted directly for 5 million jobs in 1982, including one out of every eight jobs in manufacturing industry. But export-related jobs have been getting even more important at the margin. A survey in the late 1970s indicated that four out of every five new jobs in U.S. manufacturing was coming from foreign trade; on average, it is estimated that every $1 billion increase in our exports results in 24,000 new jobs.

Later I will detail how Mexican debt problems have caused a $10 billion annual-rate drop in our exports to Mexico between the end of 1981 and the end of 1982. By the rule of thumb I just gave, that means the loss of a quarter of a million American jobs.

These figures serve to illustrate the overall importance of exports to the U.S. economy. The story can be taken one step further, to relate it more closely to the present financial situation. Our trading relations with the LDCs have expanded even more rapidly than our overall trade. Our exports to the LDCs, which accounted for about 25 percent of total U.S. exports in 1970, rose to about 29 percent by 1980. (Chart H.) In manufactured goods, which make up two-thirds of our exports, the share going to LDCs rose even more strongly -- from 29 percent to 39 percent. In fact, since the mid-1970's trade with LDCs has accounted for more than half of the overall growth of American exports.

What these figures mean is that the export sector of our economy -- a leader in creating new jobs -- is tremendously vulnerable to any sharp cutbacks in imports by the LDCs. Yet that is exactly the response to which debt and liquidity problems have been driving them. This is a matter of concern not just to the banking system, but to American workers, farmers, manufacturers and investors as well.

Even on the banking side, there are indirect impacts of concern to all Americans. A squeeze on earnings and capital positions from losses on foreign loans not only would impair banks' ability to finance world trade, but also could ultimately mushroom into a significant reduction in their ability to lend to domestic customers and an increase in the cost of that lending.

Beyond our obvious interest in maintaining world trade and trade finance, there is another less-recognized U.S. financial interest. The U.S. government faces a potential exposure through Federal lending programs administered by Eximbank and the Commodity Credit Corporation. This exposure -- built in support of U.S. export expansion -- amounted to $35 billion at the end of 1982, including $24 billion of direct credits (mostly from Eximbank) and $11 billion of guarantees and insurance. Argentina, Brazil and Mexico are high on the list of borrowers. Should loans extended or guaranteed under these programs sour, the U.S. Treasury -- meaning the U.S. taxpayer -- would be left with the loss. We have a direct interest in avoiding this addition to Federal financing requirements.

All industrial economies, including the American economy, will inevitably bear some of the costs of the balance of payments adjustments LDCs must make and are already making. This adjustment would be much deeper, for both the borrowing countries and for lending countries like the United States, if banks were to pull back entirely from new lending this year. In 1983, for example, a flat standstill would require borrowers to make yet another $20 to $25 billion cut in their trade and current account deficits, which would be considerably harder to manage if it came right on the heels of similar cuts they have already made. If these countries were somehow to make adjustments of that size for a second consecutive year, the United States and other industrial countries would then have to suffer large export losses once again. At the early stages of U.S. and world economic recovery we are likely to be in this year, a drop in export production of this size could abort the gradual rebuilding of consumer and investor confidence we need for a sustained recovery.

In fact, many borrowers have already taken very difficult adjustment measures to get this far. If they were forced to contemplate a second year of further massive cutbacks in available financing, they could be driven to consider other measures to reduce the burden of their debts. Here potentially lies a still greater threat to the financial system.

When interest payments are more than 90 days late, not only are bank profits reduced by the lost interest income, but they may also have to begin setting aside precautionary reserves to cover potential loan losses. If the situation persisted long enough, the capital of some banks might be reduced.

Banks are required to maintain an adequate ratio between their underlying capital and their assets -- which consist mainly of loans. For some, shrinkage of their capital base would force them to cut back on their assets -- meaning their outstanding loans -- or at least on the growth of their assets -- meaning their new lending. Banks would thus be forced to make fewer loans to all borrowers, domestic and foreign, and they would also be unable to make as many many investments in securities such as municipal bonds. Reduced access to bank financing would not only force a cutback in the expenditures which private corporations and local governments can make -- it would also put upward pressure on interest rates.

The usual perception of international lending is that it involves only a few large banks in the big cities, concentrated in half a dozen states. The facts are quite different. We have reliable information from bank regulatory agencies and Treasury reports identifying nearly 400 banks in 35 states and Puerto Rico that have foreign lending exposures of over $10 million --

and in all likelihood there are hundreds more banks with exposures below that threshhold but still big enough to make a significant dent in their capital and their ability to make new loans here at home. Banks in most states are involved, and the more abruptly new lending to troubled borrowing countries is cut back, the more likely it is that the fallout from their problems will feed back back on the U.S. financial system and weaken our economy. Many U.S. corporations also have claims on foreign countries, related to their exports and foreign investments.

Resolving the International Financial Problem

Debt and liquidity problems did not come into being overnight, and a lasting solution will also take some time to put into place. We have been working on a broad-based strategy involving all the key players -- LDC governments, governments in the industrialized countries, commercial banks, and the International Monetary Fund. This strategy has five main parts:

First, and in the long run most important, must be effective adjustment in borrowing countries. In other words, they must take steps to get their economies back on a stable course, and to make sure that imports do not grow faster than their ability to pay for them. Each of these countries is in a different situation, and each faces its own unique constraints. But in general, orderly and effective adjustment will not come overnight. The adjustment will have to come more slowly, and must involve expansion of productive investment and exports. In many cases it will entail multi-year efforts, usually involving measures to address some combination of the following problems: rigid exchange rates; subsidies and protectionism; distorted prices; inefficient state enterprises; uncontrolled government expenditures and large fiscal deficits; excessive and inflationary money growth; and interest rate controls which discourage private savings and distort investment patterns. The need for such corrective policies is recognized, and being acted on, by major borrowers -- with the support and assistance of the IMF.

The second element in our overall strategy is the continued availability of official balance of payments financing, on a scale sufficient to help see troubled borrowers through the adjustment period. The key institution for this purpose is the International Monetary Fund. The IMF not only provides temporary balance of payments financing, but also ensures that use of its funds is tied tightly to implementation of needed policy measures by borrowers. It is this aspect -- IMF conditionality -- that makes the role of the IMF in resolving the current debt situation and the adequacy of its resources so important.

IMF resources are derived mainly from members' quota subscriptions, supplemented at times by borrowing from official sources. Assessing the adequacy of these resources over any extended period is extremely difficult and subject to wide margins of error. The potential needs for temporary balance of payments financing depend on a number of variables, including members' current and prospective balance of payments positions, the availability of other sources of financing, the strength of the conditionality associated with the use of IMF resources, and members' willingness and ability to implement the conditions of IMF programs. At the same time, the amount of IMF resources that is effectively available to meet its members' needs at any point in time depends not only on the size of quotas and borrowing arrangements, but also on the currency composition of those resources in relation to balance of payments patterns, and on the amount of members' liquid claims on the IMF which might be drawn. In view of all these variables, assessments of the IMF's "liquidity" -- its ability to meet members' requests for drawings -- can change very quickly.

Still, as difficult as it is to judge the adequacy of IMF resources in precise terms, most factors point in the same direction at present. The resources now effectively available to the IMF have fallen to very low levels, both in absolute terms and in relation to actual and potential use of the IMF.

At the beginning of this year, the IMF had about SDR 28 billion available for lending. However, SDR 19 billion of that total had already been committed under existing IMF programs or was expected to be committed shortly to programs already negotiated, leaving only about SDR 9 billion available for new commitments. Given the scope of today's financing problems, requests for IMF programs by many more countries must be anticipated over the next year, and it is probable that the IMF's ability to commit resources to future adjustment programs will be exhausted by late 1983 or early 1984.

It is therefore clear that the Fund's liquidity position will be under extreme strain in the near future. Since actual drawings under its program commitments are phased over time and tied to the borrower's performance of policy conditions, the Fund has sufficient resources to meet its immediate short-run cash needs. But there is no provision for the future, and the margin of safety for the present is very small and shrinking rapidly. The Fund's ability to continue committing resources to adjustment programs, and to permit its current holdings to be drawn down significantly further, depends importantly on assurances that new resources will be provided soon. I will return to our specific proposals in this area shortly.

The IMF cannot be our only buffer in financial emergencies. It takes time for borrowers to design and negotiate lending programs with the IMF and to develop financing arrangements with other creditors. As we have seen in recent cases, the problems of troubled borrowers can sometimes crystallize too quickly for that process to reach its conclusion -- in fact, the real liquidity crunch came in the Mexican and Brazilian cases before such negotiations even started.

Thus, the third element in our strategy is the willingness of governments and central banks in lending countries to act quickly to respond to debt emergencies when they occur. Recent experience has demonstrated the need to consider providing immediate and substantial short-term financing -- on a selective basis, where system-wide dangers are present -- to tide countries through their negotiations with the IMF and discussions with other creditors. We are undertaking this where necessary, on a case-by-case basis, through ad hoc arrangements among finance ministries and central banks, often in cooperation with the Bank for International Settlements. But it must be emphasized that these lending packages are short-term in nature, designed to last for only a year at most and normally much less, and cannot substitute for IMF resources which are designed to help countries through a multi-year adjustment process.

In fact, IMF resources themselves have only a transitional and supporting role. The overall amount of Fund resources, while substantial, is limited and not in any event adequate to finance the needs of its members. While we feel that a sizeable increase in IMF resources is essential, this increase is not a substitute for lending by commercial banks. Private banks have been the largest single source of international financing in the past to both industrial and developing countries, and this will have to be the case in the future as well -- including during the crucial period of adjustment.

Thus, the fourth essential element in resolving debt problems is continued commercial bank lending to countries that are pursuing sound adjustment programs. In the last months of 1982 some banks, both in United States and abroad, sought to limit or reduce outstanding loans to troubled borrowers. But an orderly resolution of the present situation requires not only a willingness by banks to "roll over" or restructure existing debts, but also to increase their net lending to developing countries, including the most troubled borrowers, to support effective, non-disruptive adjustment. The increase in net new commercial bank lending needed for just three countries -- Brazil, Argentina, and Mexico -- will approach $11 billion in 1983. Without this continued lending in support of orderly and constructive economic adjustment, the programs that have been formulated with the IMF cannot succeed -- and the lenders have a strong self-interest in helping to assure success. It should be noted, however, that new bank lending will be at a slower rate than that which has characterized the last few years -- more in line with the increase in 1982 than what we saw in 1980 or 1981.

The final part of our strategy is to restore sustainable economic growth and to preserve and strengthen the free trading system. The world economy is poised for a sustained recovery: inflation rates in most major countries have receded; nominal interest rates have fallen sharply; inventory rundowns are largely complete.

Solid, observable U.S. recovery is one critical ingredient missing for world economic expansion. We believe the U.S. recovery is now getting underway, as evidenced by the recent drop in unemployment and upturns in orders and production in some key industries. Establishing credible growth in other industrial economies is also important and we believe the base for recovery is being laid abroad as well.

However, both we and others must exercise caution at this turning point. Governments must not give in to political pressures to stimulate their economies too quickly through excessive monetary or fiscal expansion. A major shift at this stage could place renewed upward pressure on inflation and interest rates.

In addition, rising protectionist pressures, both in the United States and elsewhere, pose a real threat to global recovery and to the resolution of the debt problem. When one country takes protectionist measures hoping to capture more than its fair share of world trade, other countries will retaliate. The result is that world trade shrinks, and rather than any one country gaining additional jobs, everybody loses. More importantly for current debt problems, we must remember that export expansion by countries facing problems is crucial to their balance of payments adjustment efforts. Protectionism cuts off the major channel of such expansion. That adjustment is essential to restoring problem country debtors to sustainable balance of payments positions and avoiding further liquidity crises -- and as we have seen, it is therefore essential to the economic and financial health of the United States.

The only solution is a stronger effort to resist protectionism. As the world's largest trading nation, the United States carries a major responsibility to lead the world away from a possible trade war. The clearest and strongest signal for other countries would be for the United States to renounce protectionist pressures at home and to preserve its essentially free trade policies. That signal would be followed, and would reinforce, continued U.S. efforts to encourage others to open their markets, and would in turn be reinforced by IMF program requirements for less restrictive trade policies by borrowers.

The Role and Resources of the IMF

I have stressed the role of the International Monetary Fund in dealing with the current financial situation, and now I would like to expand on that point. The IMF is the central official international monetary institution, established to promote a cooperative and stable monetary framework for the world economy. As such, it performs many functions beyond the one we are most concerned with today -- that of providing temporary balance of payments financing in support of adjustment. These include monitoring the appropriateness of its members' foreign exchange arrangements and policies, examining their economic policies, reviewing the adequacy of international liquidity, and providing mechanisms through which its member governments cooperate to improve the functioning of the international monetary system.

In that context, it becomes clearer that IMF financing is provided only as part of its ongoing systemic responsibilities. Its loans to members are made on a temporary basis in order to safeguard the functioning of the world financial system -- in order to provide borrowers with an extra margin of time and money which they can use to bring their external positions back into reasonable balance in an orderly manner, without being forced into abrupt and more restrictive measures to limit imports. The conditionality attached to IMF lending is designed to assure that orderly adjustment takes place -- and that the borrower is restored to a position which will enable it to repay the IMF over the medium term. In addition, a borrower's agreement with the IMF on an economic program is usually viewed by financial market participants as an international "seal of approval" of the borrower's policies, and serves as a catalyst for additional private and official financing.

The money which the IMF has available to meet its members' temporary balance of payments financing needs comes from two sources: quota subscriptions and IMF borrowing from its members. The first source, quotas, represents the Fund's main resource base and presently totals some SDR 61 billion, or about $67 billion at current exchange rates. The IMF periodically reviews the adequacy of quotas in relation to the growth of international transactions, the size of likely payments imbalances and financing needs, and world economic prospects generally.

At the outset of the current quota discussions in 1981, many IMF member countries favored a doubling or tripling of quotas, arguing both that large payments imbalances were likely to continue and that the IMF should play a larger intermediary role in financing them. While agreeing that quotas should be adequate to meet prospective needs for temporary financing, the United States felt that effective stabilization and adjustment measures should lead to a moderation of payments imbalances. We did not support the view that the IMF should become a regular source of financing, a more or less permanent intermediary between borrowers and lenders. Nor did we feel that a massive quota increase would be an efficient way to equip the IMF to deal with sudden and potentially major financing problems that could threaten the stability of the system as a whole, and for which the IMF's resources were inadequate.

Accordingly, the United States proposed a dual approach to strengthening IMF resources:

- -- First, a quota increase which, while smaller than many others had wanted, could be expected to position the IMF to meet members' needs for temporary financing in normal circumstances.
- -- Second, establishment of a contingency borrowing arrangement that would be available to the IMF on a stand-by basis for use in situations threatening the stability of the system as a whole.

This approach has been adopted by the IMF membership, in agreements reached by the major countries in the Group of Ten in mid-January, and by all members at the IMF's Interim Committee meeting last week.

The agreed increase in IMF quotas is 47 percent, an increase from SDR 61 billion to SDR 90 billion (in current dollar terms, an increase from $67 billion to $99 billion). The proposed increase in the U.S. quota is SDR 5.3 billion ($5.8 billion at current exchange rates) representing 18 percent of the total increase.

The Group of Ten, working with the IMF's Executive Board, has agreed to an expansion of the IMF's General Arrangements to Borrow from the equivalent of about SDR 6.5 billion at present to a new total of SDR 17 billion, and to changes in the GAB to permit its use, under certain circumstances, to finance drawings on the IMF by any member country. Under this agreement, the U.S. commitment to the GAB would rise from $2 billion to SDR 4.25 billion, equivalent to an increase of $2.6 billion at current exchange rates.

We believe this expansion and revision of the GAB offers several important attractions and, as a supplement to the IMF's quotas, greatly strengthens the IMF's role as a backstop to the system:

-- First, since GAB credit lines are primarily with countries that have relatively strong reserve and balance of payments positions, they can be expected to provide more effectively usable resources than a quota increase of comparable size. Consequently, expansion of the GAB is a more effective and efficient means of strengthening the IMF's ability to deal with extraordinary financial difficulties than a comparable increase in quotas.

-- Second, since the GAB will not be drawn upon in normal circumstances, this source of financing will be conserved for emergency situations. By demonstrating that the IMF is positioned to deal with severe systematic threats, an expanded GAB can provide the confidence to private markets that is needed to ensure that capital continues to flow, thus reducing the risk that the problems of one country will affect others.

-- And third, creditors under this arrangement will have to concur in decisions on its activation, ensuring that it will be used only in cases of systemic need and in support of effective adjustment efforts by borrowing countries.

Annex A to my statement contains the texts of the relevant Interim Committee and Group of Ten communiques. These substantive agreements will be codified in formal Governors and Executive Board decisions in the next few weeks. In sum, the proposed increase in U.S. commitments to the IMF totals SDR 7.7 billion -- SDR 5.3 billion for the increase in the U.S. quota and SDR 2.4 billion for the increase in the U.S. commitment under the GAB. At current exchange rates, the dollar equivalents are $8.4 billion in total, $5.8 billion for the quota increase and $2.6 billion for the GAB increase.

We believe these steps to strengthen the IMF, if enacted, will safeguard the IMF's ability to respond effectively to current financial problems. Given the financing needs we foresee, we feel it is important that the increases be implemented by the end of this year. Without such a timely and adequate increase in IMF resources, the ability of the monetary system to weather debt and liquidity problems will be impaired, at substantial direct and indirect cost to the United States.

The IMF is essentially a non-political institution, with membership open to any country judged willing and able to meet the obligations of membership. But this does not mean that U.S. political and security interests are not served by the IMF. On the contrary -- it serves our interests well by containing economic problems which could otherwise spread through the international community; minimizing political instability in countries facing the inevitable social and economic dislocations which accompany adjustment; and supporting open, market-oriented economic systems consistent with Western political values. Judged on this criterion, U.S. appropriations for the IMF can be an excellent investment if they can help to avoid political upheaval in countries of critical interest to the United States.

While this is the first time I have appeared before Congress to support these specific agreements and proposals to increase IMF resources, the general issues and outline are familiar to members of the Committee. Many of you have expressed reservations or questions about this proposal, and I would like to discuss the main concerns now.

Is the IMF "Foreign Aid"?

Many perceive money appropriated for IMF use to be just another form of foreign aid, and question why we should be providing U.S. funds dollars to foreign governments. Let me assure you that the IMF is not a development institution. It does not finance dams, agricultural cooperatives, or infrastructure projects. I have already made the point that the IMF is a monetary institution. Only one of its functions is providing balance of payments financing to its members in order to promote orderly functioning of the monetary system, and only then on a temporary basis, on medium-term maturities, after obtaining agreement to the fulfillment of policy conditions. We have been working very hard with the IMF to ensure that both the effectiveness of IMF policy conditions, and the temporary nature of its financing, are safeguarded. In this way, the Fund's financing facilities will continue to have a revolving nature and to promote adjustment.

IMF conditionality has been controversial over the years, with strong opinions on both sides. Some observers have worried that conditionality is so weak and ineffective that conditional lending is virtually a giveaway. Others believe that conditionality is too tight -- that it imposes unnecessary hardship on borrowers, and stifles economic growth and development.

Such generalizations reflect a misunderstanding of IMF conditionality. When providing temporary resources to a country faced with external financing problems, the IMF seeks to assure itself that the country is pursuing policies that will enable it to live within its means -- that is, within its ability to obtain foreign financial resources. It is this that determines the degree of adjustment that is necessary. It is often the case that appropriate economic policies will strengthen a country's borrowing capacity, and result in both higher import growth and higher export growth. In this connection, I would cite the example of Mexico as an immediate case in point.

Mexico is our third largest trading partner, after Canada and Japan. And, as recently as 1981, it was a partner with whom we had an export boom and a substantial trade surplus, exporting goods to meet the demands of its rapidly growing population and developing economy. This situation changed dramatically in 1982, as Mexico began experiencing severe debt and liquidity problems. By late 1982, Mexico no longer had access to financing sufficient to maintain either its imports or its domestic economic activity. As a result, U.S. exports to Mexico dropped by a staggering 60 percent between the fourth quarter of 1981 and the fourth quarter of 1982. Were our exports to Mexico to stay at their depressed end-1982 levels, this would represent a $10 billion drop in exports

exports to our third largest market in the world. Because the financing crunch got worse as the year wore on, totals for the full year 1982 don't tell the story quite so dramatically -- but even they are bad enough. Our $4 billion trade surplus with Mexico in 1981 was transformed into a trade deficit of nearly $4 billion in 1982, due mainly to an annual-average drop in U.S. exports of one-third. (Chart I.) This $8 billion deterioration was our worst swing in trade performance with any country in the world, and it was due almost entirely to the financing problem.

We believe that now this situation will start to turn around, and we can begin to resume more normal exports to Mexico. If this happens, it will be due in large part to the fact that, late in December, an IMF program for Mexico went into effect; and that program is providing the basis not only for IMF financing, but for other official financing and for a resumption of commercial bank lending as well. Mexico must make difficult policy adjustments if it is to restore creditworthiness. The Mexican authorities realize this and are embarked on a courageous program. But the existence of IMF financing and the other financing associated with it will permit Mexico to resume something more like a normal level of economic activity and imports while the adjustment takes place in an orderly manner. Without the IMF program, all we could look forward to would be ever-deepening depression in Mexico and still further declines in our exports to that country.

There is another aspect of the distinction between IMF financing and foreign aid which we should be very clear on, since it goes to the heart of U.S. relations with the Fund. All IMF members provide financing to the IMF under their quota subscriptions, and all -- industrial and developing alike -- have the right to draw on the IMF. Quota subscriptions form a kind of revolving fund, to which all members contribute and from which all are potential borrowers.

As an illustration, in practice our quota subscription has been drawn upon many times -- and repaid -- over the years for lending to other IMF members. We in turn have drawn on the IMF on 24 occasions -- most recently in November 1978 -- and our total cumulative drawings, amounting to the equivalent of $6.5 billion, are the second largest of any member (the United Kingdom has been the largest user of IMF funds). (U.S. drawings on the IMF are described at Annex B.)

Why Spend Money on the IMF?

Another major concern with the proposals to increase IMF resources is that, in this period of budgetary stringency, many believe we would be better advised to spend the money at home. There is also some feeling that if we were to get the U.S. economy moving forward again, the international financial problem would take care of itself. I think I've already been through part of the response to these concerns when I described the large and growing impact which foreign trade now has on American growth and employment. We will do what is necessary domestically to strengthen our economy. But we will leave a major threat to domestic recovery unaddressed if we do not act to resolve the international financial situation. The direct impact alone of international developments on our economy is so large that, were the international situation not to improve, there would at a minimum be a tremendous drag on our economic recovery.

It is true that an improving U.S. economy is going to help other nations, both through our lower interest rates and through an expanding U.S. market for their exports -- providing of course that we don't cut them off from that market. But they also have an immediate, short-run financing crunch to get through, and if we don't handle that right there are substantial downside risks for the United States.

This might also be the right context in which to discuss how U.S. participation in the increase in IMF resources would affect the Federal budget and the Treasury's borrowing requirements. Under budget and accounting procedures adopted in connection with the last IMF quota increase, in consultation with the Congress, both the increase in the U.S. quota and the increase in the U.S. commitment under the GAB will require authorization and appropriation by the Congress. Because the United States receives a liquid, interest-earning reserve claim on the IMF in connection with our actual transfers of cash to the IMF, such transfers do not result in net budget outlays or an increase in the Federal budget deficit.

Actual cash transactions with the IMF, under our quota subscription or U.S. credit lines, do affect Treasury borrowing requirements. The amount in any year depends on a variety of factors, including the rate of use of IMF resources; the degree to which the dollar is used in IMF drawings and repayments to the IMF; and whether the United States itself draws on the IMF. An analysis appended to this statement at Annex C presents data on the impact of U.S. transactions between 1970 and 1982 on Treasury borrowing requirements. Although there have been both increases and decreases in Treasury borrowing requirements from year to year, on average there have been increases amounting to $454 million annually over the entire 13 year period, for a cumulative total of over $6 billion. The rate has picked up in the last two years of heavy IMF activity, as would be expected; but the total is still relatively small -- the $454 million annual impact is only a small part of the $54 billion annual average Federal borrowing requirement over the same period, and the $6 billion cumulative impact compares with an outstanding Federal debt of $1.2 trillion at the end of 1982. These figures also serve to demonstrate the revolving nature of the IMF.

Is the IMF a Bank "Bail-Out"?

I also know there is a widespread concern that an increase in IMF resources will amount to a bank bail-out at the expense of the American taxpayer. Many would contend that the whole debt and liquidity problem is the fault of the banks -- that they've dug themselves and the rest of us into this hole though greed and incompetence, and now we intend to have the IMF take the consequences off their hands. This line of argument is dangerously misleading, and I would like to set the record straight.

First, the steps that are being taken to deal with the financial problem, including the increase in IMF resources, require continued involvement by the banks. Far from allowing them to cut and run, orderly adjustment requires increased bank lending to troubled LDCs that are prepared to adopt serious economic programs. That is exactly what is happening.

And it is not a departure from past experience. I have had Treasury staff review IMF program experience in the 20 countries which received the largest net IMF disbursements in the last few years, to see whether banks had been "bailed out" in the past. Looking at the period from 1977 to mid-1982, they found that for the countries which rely most heavily on private bank financing, IMF programs have been followed up by new bank lending much greater than the amount disbursed by the Fund itself. This also holds true for the 20 countries as a group: net IMF disbursements to this group during the period were $11.5 billion, while net bank lending totalled $49.7 billion, resulting in a ratio of 4.3 to 1 during this period.

The second point I would like to stress here is the notion that the increase in IMF resources is coming mainly from the United States. The U.S. share in the increase in IMF resources is 18 percent -- which obviously means other countries are putting up the remaining 82 percent, the great bulk of the increase. By putting up 18 percent of the increase, we will maintain our voting share at just over 19 percent. The principle of weighted voting on which the IMF operates has been key to its effectiveness over the years and to ensuring that we have a voice and vote comparable to the share of resources we provide. Major policy decisions -- such as those just taken on the quota increase -- require an 85 percent majority vote, which means that we have a veto over all such decisions. Some of our allies would claim that we aren't pulling our own weight -- that our stake in world trade and finance is bigger than the share of resources we are proposing to put into the IMF would indicate.

The third point I would like to make is that the whole debt and liquidity problem cannot fairly be said to be the fault of the commercial banks. In fact, the banking system as a whole performed admirably over the last decade, in a period when there were widespread fears that the international monetary system would fall apart for lack of financing in the aftermath of the oil shocks. The banks managed almost the entire job of "recycling" the OPEC surplus and getting oil importers through that difficult period. Some of the innovations and decisions that banks made in the process, which seemed rational and necessary at the time to them and to others, may seem doubtful in retrospect, given the way the world economic environment changed. But I think we can agree that governments have had a great deal to do with shaping that environment.

All of this is not to say that there aren't lessons to be learned in the banking area -- there clearly has been an element of lack of prudence in lending decisions, and of overlending. So we should be asking ourselves: What is there that banks could be doing to improve their screening of foreign loans? What is there that bank regulators could do to improve on their analysis of country risk, examination of bank exposure, and consultations with senior management?

Our basic starting point in addressing these questions is a belief that the U.S. government should not get into the business of dictating the lending practices of private banks. Doing so would inject a political element into what should be business decisions, and would potentially expose the government to liability for covering loans that were not repaid on time. Moreover, in general it is bank managements, which have direct experience and a responsibility to their shareholders and depositors to motivate them, that are in the best position to make lending decisions.

In 1979, the bank regulatory agencies (the Federal Reserve, Comptroller of the Currency and the FDIC) instituted a new system for evaluating country risk, which has four elements. The first is a statistical reporting system designed to identify country exposures at each bank, and to enable regulators to monitor those exposures. Second is an evaluation of each bank's internal system for managing country risk, aimed at encouraging more systematic review of prospective loans. Third, where there is a judgment by regulators that a country has interrupted its debt service payments, or is about to do so, all loans to that country may be "classified" as substandard, doubtful, or a total loss, and such "classification" may trigger an obligation by the bank to set aside precautionary loan loss reserves. Fourth, bank examiners review and comment upon each bank's large foreign lending exposures, drawing upon the findings of an interagency committee of country analysts.

There are several possible changes that could be made in the regulatory environment. One would be to set up formal limits on each bank's exposure in different countries by law or regulation, in effect setting up "single country" limits analogous to the "single borrower" limits which are already used. Such limits on country exposure would necessarily be highly arbitrary and unable to distinguish among the capabilities of different banks or among the size and financial health of different countries, especially if applied by law. If applied judgmentally, on the other hand, such "single country" limits would require that the U.S. government make controversial economic and political judgments about other countries. The present system, which uses various ratios of exposure as a percentage of capital as a threshhold point for commenting upon loans to certain countries, is more flexible and should be a useful basis for our future procedures. More intensive discussion with senior bank management during the examination process would probably be desirable.

Another possibility, which has been discussed with banks here and abroad, would be to require banks to meet specific criteria in establishing precautionary loan loss reserves against troubled loans, or even just against particularly large ones. Current procedures are not uniform across banks, and since setting aside such reserves reduces current earnings, there is some reluctance to do so unless absolutely required. Also, in the case of "sovereign loans" to public-sector borrowers, the argument is often made that the borrower cannot simply "disappear" or go bankrupt in the sense that a private borrower could, so that interest and principal arrears are certain to be recovered. However, the current situation shows that sovereign borrowers, too, can have protracted difficulties, and that their difficulties can have a more abrupt impact than would be the case if provisions against possible loan loss had been made more routinely over time.

Additionally, there is the question of whether banks' current disclosure of the size, distribution, terms, and status of their foreign loans is sufficient. Depositors have a legitimate interest in knowing what banks are doing with the money entrusted to them. Regulatory agencies have been considering this issue, and there has been some movement toward greater disclosure. Here again, there is reason to proceed with caution. When foreign lending is in vogue, the disclosure that competiting banks are expanding their foreign loans might generate pressure for other banks to do the same, even where it is against their best judgment. When attitudes move the other way, markets may overreact on the basis of hasty or naive readings of the data. The desire of borrowers for confidentiality and other competitive considerations may also limit the degree of disclosure.

Both in the banking regulatory agencies, and at the Treasury, we will be reviewing these and other issues to see what changes might be desirable. We need to be careful in determining how to deal with such a sensitive and central part of our economy. Any decisions in this area will have important implications both for resolving the present situation, and for the evolution of the banking system in the future. Chairman Volcker, Comptroller Conover, and FDIC President Isaac are scheduled to appear before a Subcommittee of the Banking Committee on Thursday to discuss these matters in more detail.

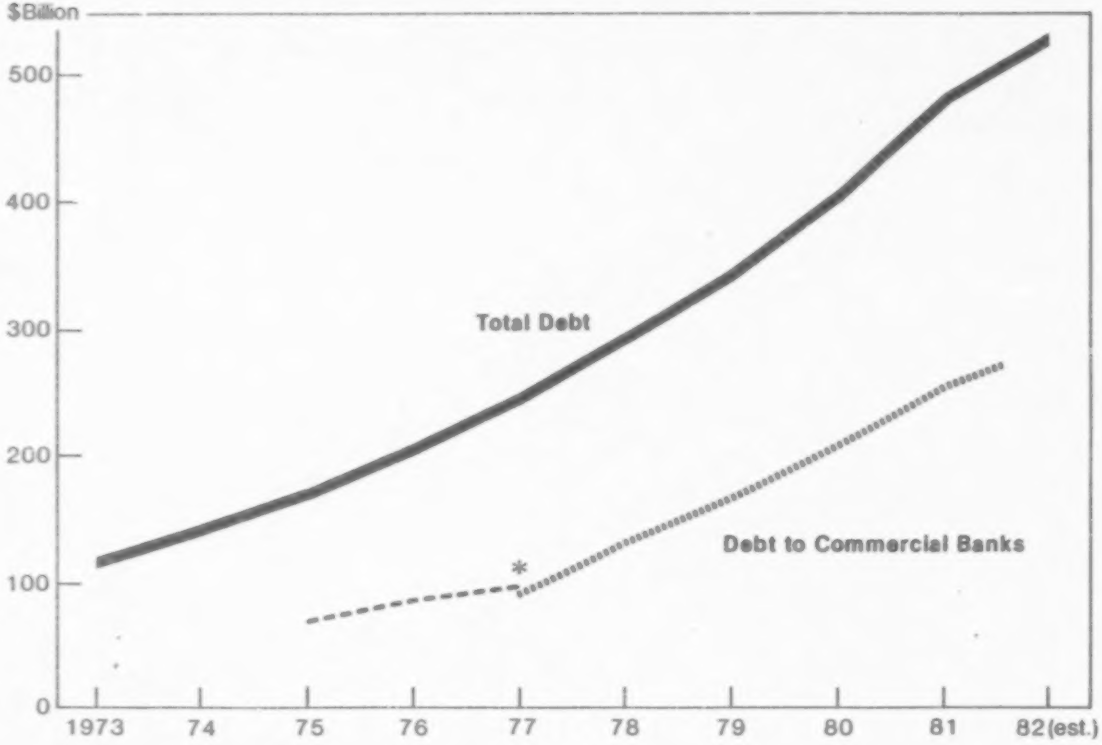
Conclusion

The IMF plays a crucial role in the solution to current debt and liquidity problems, and in providing the environment for world recovery. It is absolutely essential that the proposed increase in IMF resources become effective by the end of this year, to enable the IMF to meet these responsibilities. Prompt U.S. approval is important not only because the financing is needed, but also because it would be a sign of confidence to other governments and to the public, and would help lay to rest concerns about the risks to global recovery.

But most importantly, timely approval of these proposals is essential to our own economic interests -- to the prospects for American businesses and American jobs. The legislation will be submitted to you in a very few days. I urge that you give it prompt and favorable consideration.

CHART A

OUTSTANDING FOREIGN DEBT OF OIL-IMPORTING LDCs



* Series break.

U.S. Treasury Dept.
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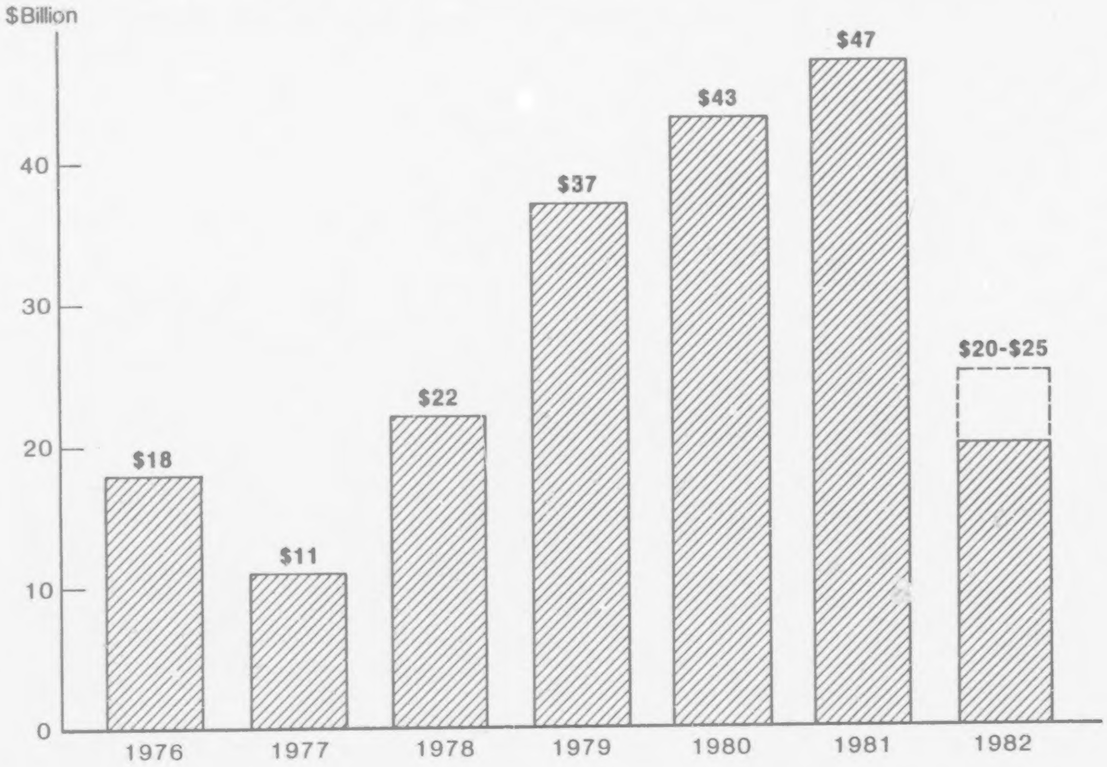
CHART B

NET NEW LENDING BY COMMERCIAL BANKS TO OIL-IMPORTING LDCs



U.S. Treasury Dept.
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CHART C

GROWTH OF U.S. AND WORLD EXPORT VOLUME

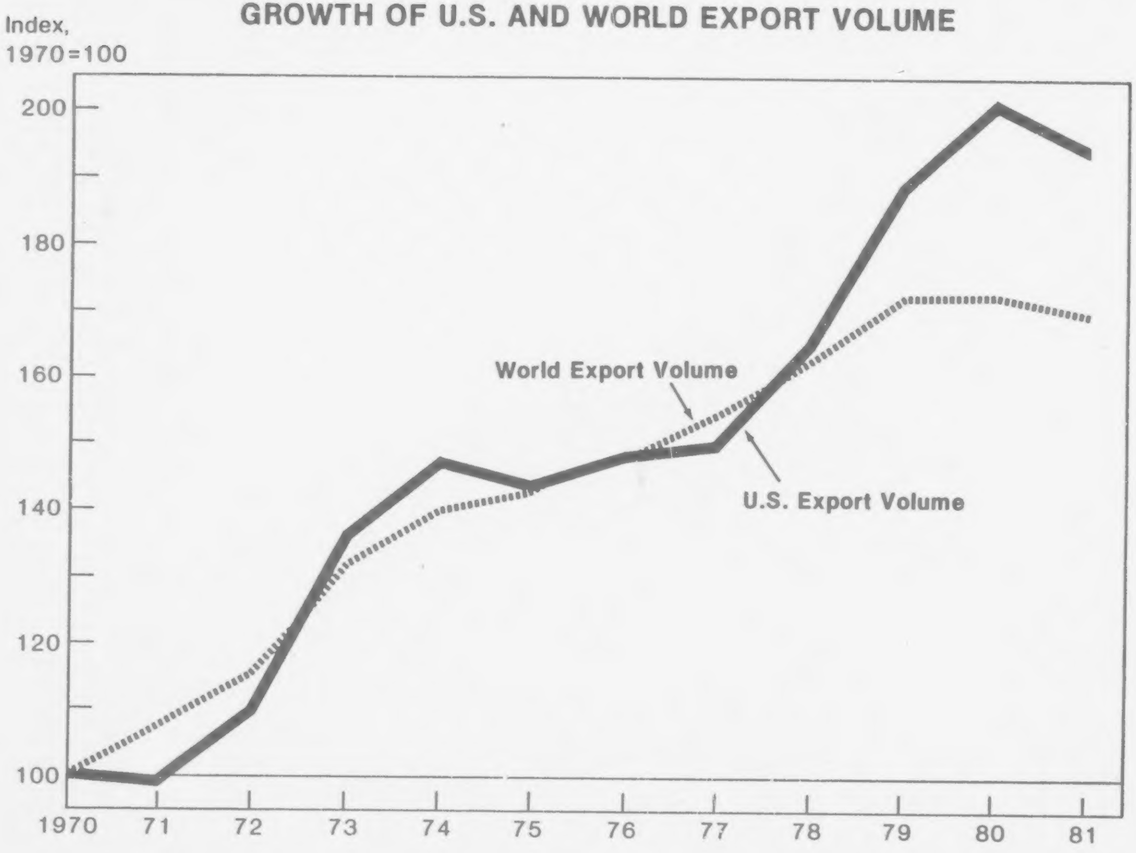

CHART D

SHARE OF U.S. EXPORTS IN TOTAL U.S. GOODS OUTPUT

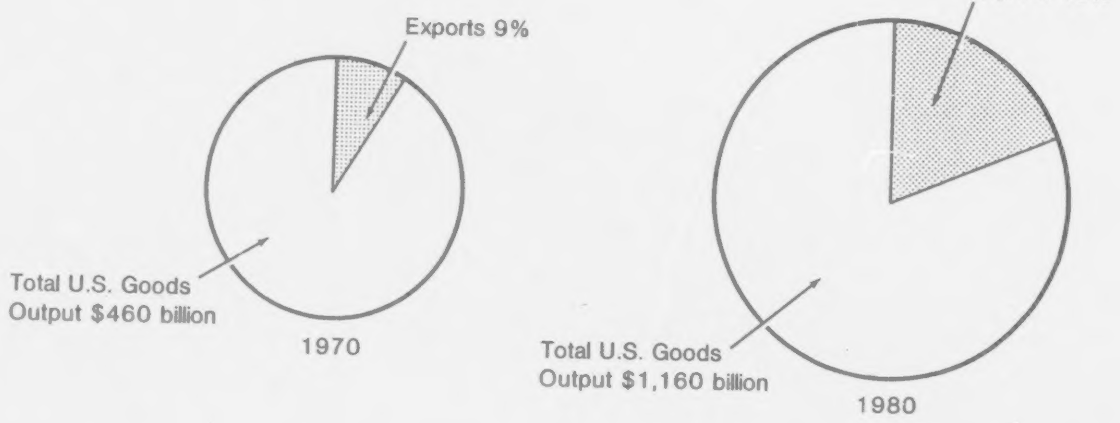

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CHART E

U.S. AGRICULTURAL EXPORTS

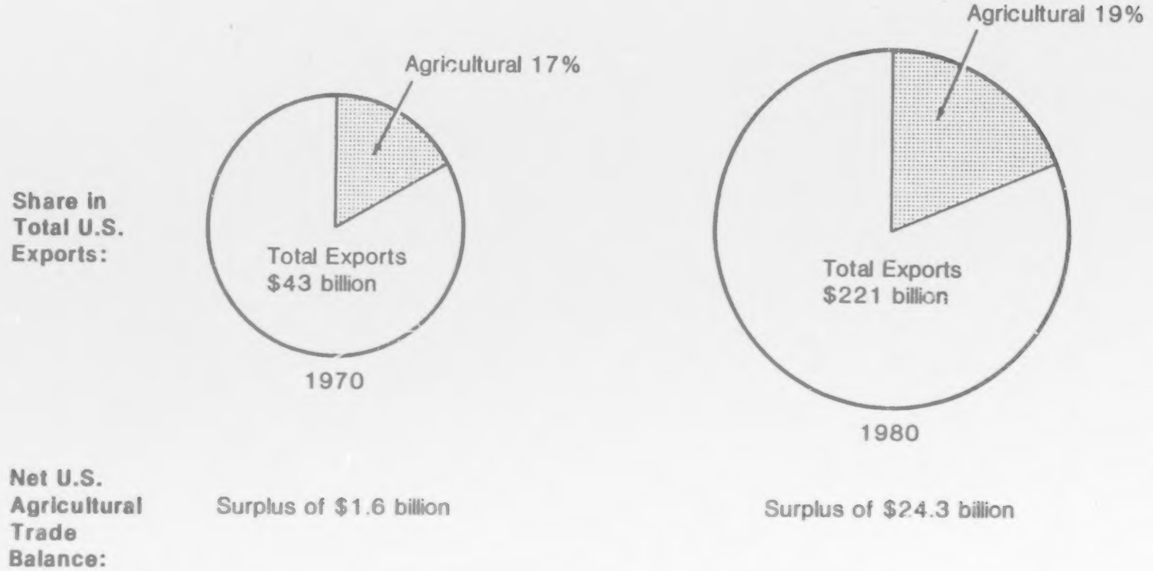

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CHART F

U.S. TRADE BALANCE IN SERVICES

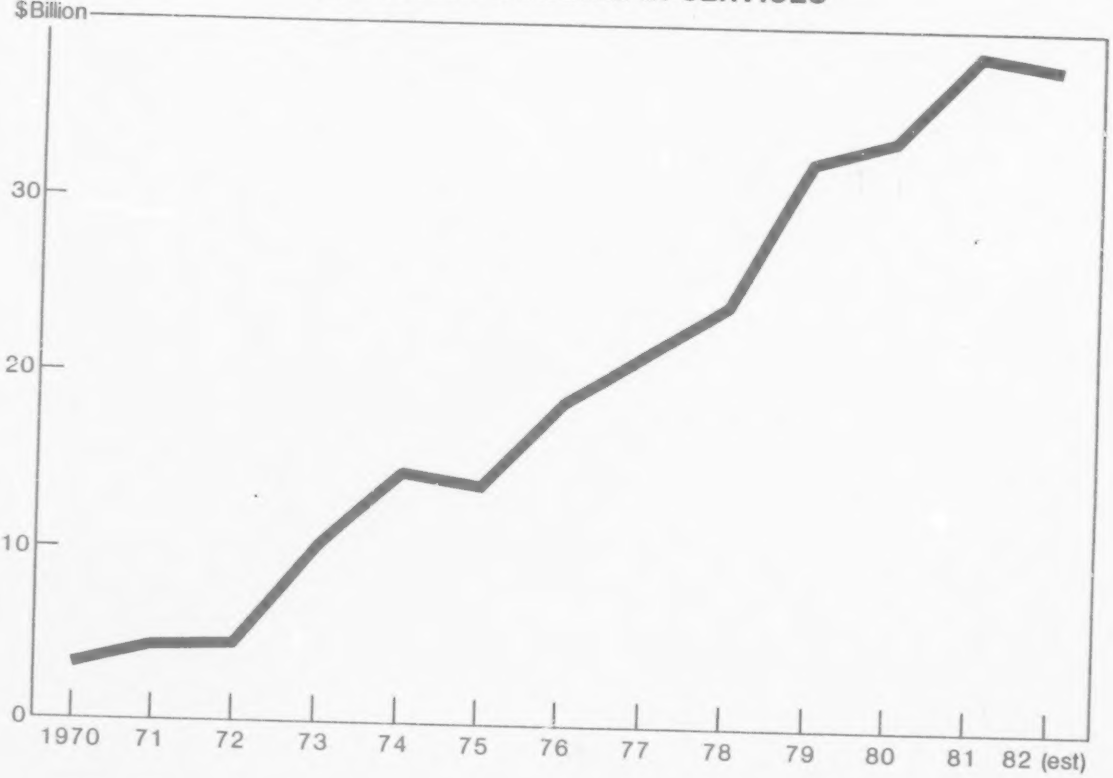

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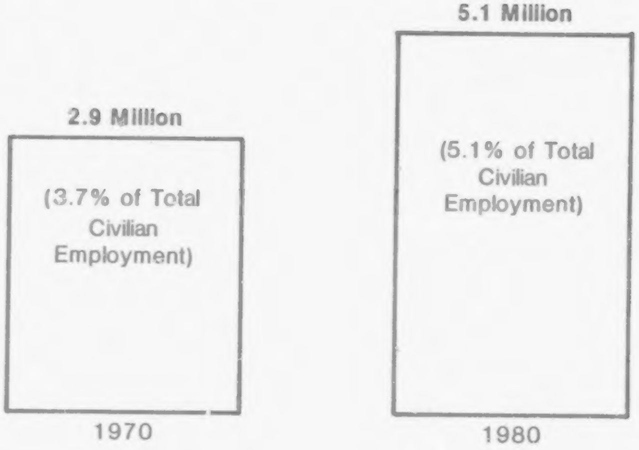
CHART G

U.S. EXPORT-RELATED JOBS



As of 1980, each $1 billion of U.S. exports was estimated to result in 24,000 jobs.

Source: Commerce Department (ITA) estimates.

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2-11-83

CHART H

U.S. EXPORTS TO OIL-IMPORTING LESS DEVELOPED COUNTRIES

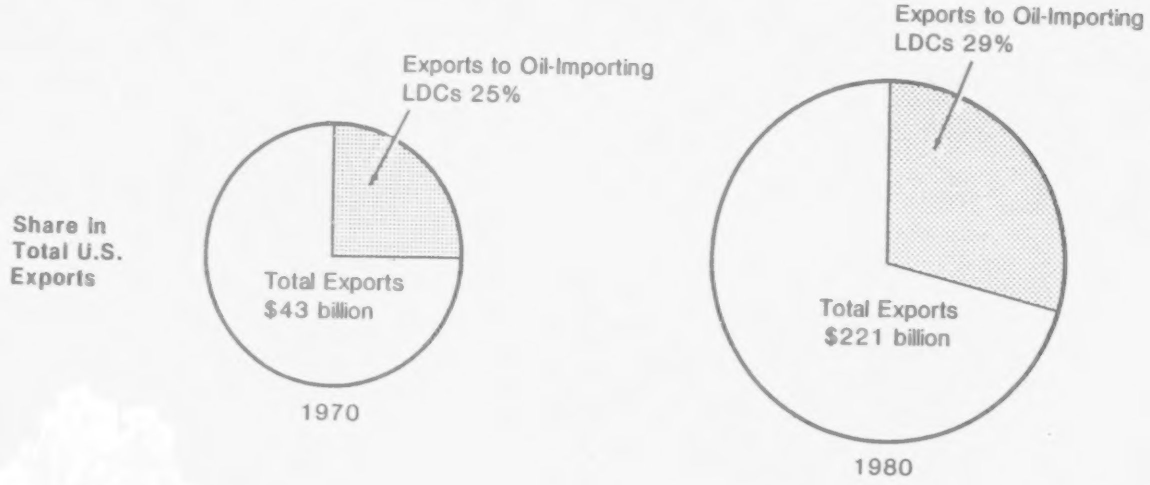

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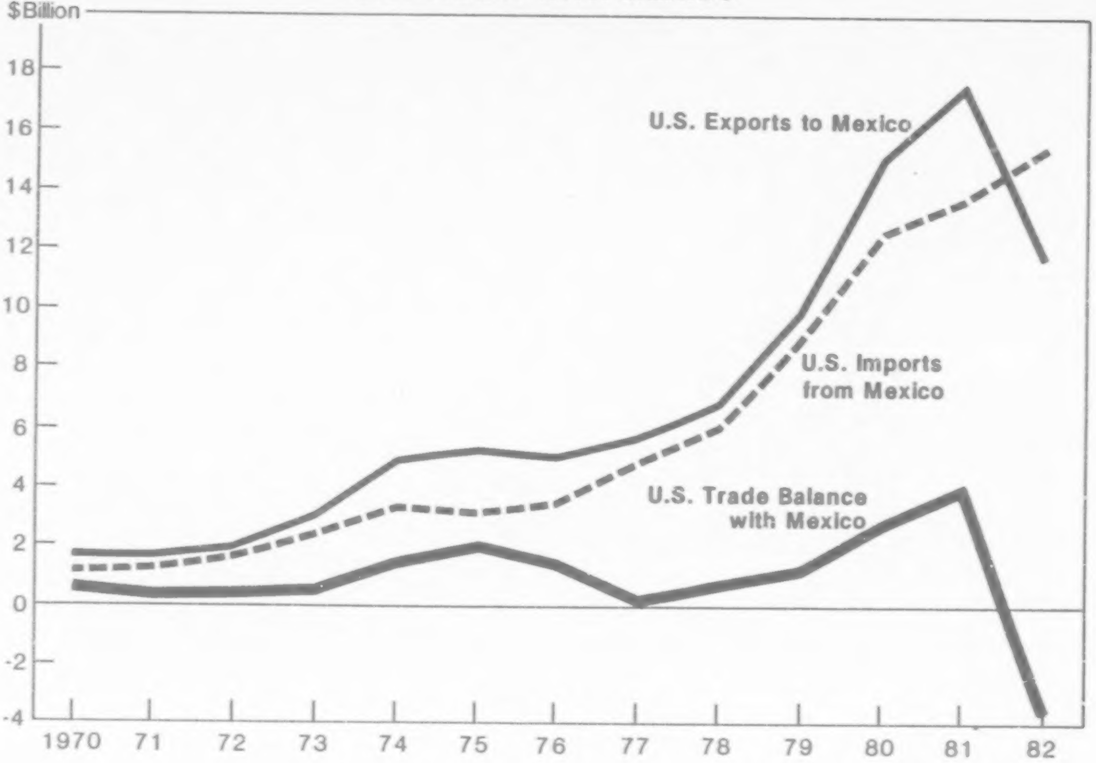
CHART I

U.S. TRADE WITH MEXICO



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2-11-83

INTERNATIONAL
MONETARY FUND

ANNEX A

Press Release NO. 83/11

FOR IMMEDIATE RELEASE
February 11, 1983

Press Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund

1. The Interim Committee of the Board of Governors of the International Monetary Fund held its twentieth meeting in Washington, D.C., on February 10 and 11, 1983, under the chairmanship of Sir Geoffrey Howe, Chancellor of the Exchequer of the United Kingdom. Mr. Jacques de Larosière, Managing Director of the International Monetary Fund, participated in the meeting. The meeting was also attended by observers from a number of international and regional organizations and from Switzerland.

2. The Committee discussed the World Economic Outlook and the policies needed to cope with the difficult problems faced by most members of the Fund.

The Committee noted that estimated rates of both growth of output and inflation had been revised downward since its previous meeting in September 1982. Anxiety was expressed at the high level of unemployment and the weakness of investment and world trade, against the background of only limited indications of economic recovery. At the same time, the Committee welcomed the further progress made by some of the larger industrial countries in their fight against inflation, as well as the reduction in interest rates that had been facilitated by this progress—developments that were providing the basis for a sustainable recovery in economic activity.

Believing that successful handling of the inflation problem is a necessary—albeit not sufficient—condition for sustained growth over the medium term, the Committee urged national authorities, in their efforts to promote sustained recovery, to avoid measures that might generate harmful expectations with regard to inflation. The importance of reducing fiscal deficits in a number of countries was also emphasized. Otherwise, the Committee noted, high real interest rates detrimental to the process of recovery could be generated by market expectations regarding government borrowing requirements.

It was the Committee's view that, in several major industrial countries where inflation remained relatively high, present circumstances called for continued restraint in monetary and fiscal policies, along with effective implementation of the incomes policies now in place. It was felt, however, that conditions for economic recovery had improved in those large industrial countries that have been able to achieve the greatest measure of success in reducing and controlling inflation. This success--and the reduction in interest rates that it has permitted--provided the basis, within the pursuit of counter-inflationary monetary and fiscal policies, for greater real growth of activity. The transition to a more stable path of real growth would be further facilitated by determined efforts to reduce market rigidities and structural imbalances.

The Committee deplored the upsurge of protectionist pressures in the past year or two. It stressed the paramount importance of resisting these pressures and, indeed, rolling them back.

The unsatisfactory situation facing non-oil developing countries was a source of particular concern to the Committee, which noted that growth rates in these countries, after averaging about 6 per cent in the 1960s and early 1970s, had averaged only 2 1/2 per cent during the past two years and were not expected to show much improvement in 1983. The Committee also observed that the modest recent increases in output, which were barely sufficient to keep pace with rapid population growth, had been achieved against a background of deteriorating terms of trade, sluggish markets for exports, high interest rates in international financial markets, and strains in the financing of current account deficits. These conditions had necessitated a sharp compression of imports by the non-oil developing countries--which, in turn, had been achieved at the cost of lower investment and growth.

Noting the extent of the external adjustment already achieved by many non-oil developing countries and the uncertainties that most such countries face in financing their current account deficits, the Committee attached great importance to the continuing provision of both official development assistance and private banking flows on an adequate scale, and it welcomed the special role recently played by the Fund in this connection.

More generally, the Committee stressed the enhanced importance, in current circumstances, of the Fund's role in providing its balance of payments assistance to member countries that engage in adjustment programs and in exercising firm surveillance over policies, and also the need to equip the Fund with adequate resources to perform this role.

3. The Committee, noting the progress made by the Executive Board on the various issues of the Eighth General Review of Quotas, focused its attention on the remaining issues, and took satisfaction in being able to reach the following agreement on the subject of quotas:

(a) The total of Fund quotas should be increased under the Eighth General Review from approximately SDR 61.03 billion to SDR 90 billion (equivalent to about US$ 98.5 billion).

(b) Forty per cent of the overall increase should be distributed to all members in proportion to their present individual quotas, and the balance of sixty per cent should be distributed in the form of selective adjustments in proportion to each member's share in the total of the calculated quotas, i.e., the quotas that broadly reflect members' relative positions in the world economy.

(c) Twenty-five per cent of the increase in each member's quota should be paid in SDRs or in usable currencies of other members.

The Committee considered the possibility of a special adjustment of very small quotas, i.e., those quotas that are currently less than SDR 10 million. It was agreed to refer this matter to the Executive Board for urgent consideration in connection with the implementation of the main decision.

4. The question of the limits on access to the Fund's resources was raised in the Committee. It was noted that the Executive Board will review this matter before June 30, 1983. The Committee invited the Executive Board to take note of the views expressed in the Committee by those favoring maintenance of the present enlarged limits in terms of multiples of quotas and also by those stressing the need to have regard to developments in the Fund's liquidity. It also invited the Managing Director to report on this matter at the next meeting of the Committee.

5. The Committee noted the recent decision of the Finance Ministers and Central Bank Governors of the participants in the General Arrangements to Borrow (GAB) to support an increase in the total amount of the commitments under these Arrangements to SDR 17 billion (equivalent to about US$19 billion) and to make the resources of these Arrangements available to the Fund to finance also purchases by nonparticipants when the Fund faces an inadequacy of resources arising from an exceptional situation involving a threat to the stability of the international monetary system. In this connection, the Committee welcomed the intention of Switzerland to become a full participant in the Arrangements, through the Swiss National Bank, with a credit commitment of SDR 1,020 million.

The Committee also welcomed the willingness of Saudi Arabia to provide resources to the Fund, in association with the GAB, and for the same purposes as those of the GAB. They noted with satisfaction the progress that is being made in setting out the detailed features of this association.

6. The members of the Committee requested the Executive Board to adopt, before the end of February 1983, the necessary decisions and other actions to implement the consensus reached in the Committee. They also agreed to urge the governments of their constituencies to act promptly so that the proposals for the increase in the Fund's resources could be made effective by the end of 1983.

7. The Committee considered again the question of allocations of SDRs in the current, i.e., the fourth, basic period which began on January 1, 1982. Noting the developments since its Toronto meeting, the Committee agreed that the matter should be reexamined as soon as possible. It, therefore, requested the Executive Board to review the latest trends in growth, inflation and international liquidity, with a view to enabling the Managing Director to determine, not later than the next meeting of the Interim Committee, whether a proposal for a new SDR allocation could be made that would command broad support among members of the Fund.

8. The Committee agreed to hold its next meeting in Washington, D.C., on September 25, 1983.

January 18, 1983

Group of Ten - Press Communiqué of the Ministers and Governors

1. The Ministers and central bank Governors of the ten countries participating in the General Arrangements to Borrow (GAB) met in Paris on January 18, 1983 under the chairmanship of Mr. Jacques Delors, Minister of Economy and Finance of France. The Managing Director of the International Monetary Fund (IMF), Mr. Jacques de Larosière, took part in the meeting, which was also attended by Mr. F. Leutwiler, President of the Swiss National Bank, Mr. E. Van Lennep, Secretary-General of the Organisation for Economic Cooperation and Development (OECD), Mr. A. Lamfalussy, Assistant General Manager of the Bank for International Settlements, and Mr. F.-X. Ortoli, Vice-President of the Commission of the European Communities.

2. The Ministers and Governors heard a report by the Chairman of their Deputies, Mr. Lamberto Dini, on issues relating to the revision and expansion of the GAB and the Eighth General Review of Quotas of the IMF. They also heard a report by the Chairman of the Working Party No. 3 of the Economic Policy Committee of the OECD, Mr. Christopher Mcmahon, on the world economic outlook.

3. In addressing the world economic situation, the Ministers and Governors welcomed recent successes in the fight against inflation and prospects for further progress. They looked toward sound monetary and fiscal policies and appropriate moderation in the growth in incomes to encourage lower interest rates, expanding trade, higher employment, and durable economic growth. These desirable developments must not be thwarted by trade restrictions or by disruption of the international financial system. At the same time, it was recognized that soundly based growth would itself help ease current tensions. To these ends, the Ministers and Governors affirmed their support for a reinforced cooperation among industrialized countries on economic, financial, and trade policies.

They considered that a sustainable improvement in activity in the industrial countries in 1983 can make an important contribution to a lasting solution of the indebtedness problem of many developing countries and to limiting the unemployment problem in all countries. Therefore, they noted with satisfaction that the competent international organizations will examine whether further steps can be taken to ensure renewed and sustained growth, and will report to the next ministerial councils, notably in the OECD and IMF framework.

4. Against this background, the Ministers and Governors discussed the international financial situation. They noted that, while strains remained in the system and the foreign debt problems of a number of countries were still a cause for real concern, governments and monetary authorities had been cooperating actively and effectively with international monetary institutions and commercial banks to reinforce the stability of the system. In order to ensure the continuing ability of the financial system to cope with existing strains and to facilitate the adjustment process, they strongly supported a substantial increase of resources available to the International Monetary Fund.

5. In light of the foregoing, the Ministers and Governors have decided, subject to the necessary legislative approval, that their aggregate credit commitments under the GAB should be promptly increased—from SDR 6.4 billion to SDR 17 billion (equivalent to an increase from $7.1 billion to about $19 billion). They welcomed the intention of Switzerland to become a full-scale participant in the GAB and decided that necessary adjustments in the arrangements should be made so as to permit the participation of Switzerland at an early date. They also decided an adjustment of the participants' shares in the arrangements so as to reflect better their size and role in the international economy and their ability to provide financial resources. A list of the new credit commitments that have been agreed is attached. They further agreed that in the future the GAB would be available not only for drawings by participants but also for purchases from the Fund for conditional financing for all its members, including members that are not GAB participants, when the Fund was faced with an inadequacy of resources arising from an exceptional situation associated with requests from countries with balance of payments problems of a character or of aggregate size that could pose a threat to the stability of the international monetary system.

6. The Ministers and Governors also looked to the conclusion of arrangements with other countries that might be willing and able to provide substantial resources to the Fund for the same purposes and on terms not unlike those agreed under the GAB. In this regard, the Ministers and Governors welcomed the recent contacts that the Chairman of the Group of Ten, and the

Chairman of the Interim Committee and the Managing Director of the Fund, have had with the authorities of Saudi Arabia. They asked the Chairman of the G-10 Deputies, in collaboration with the Managing Director of the IMF, to resume such contacts as soon as possible.

7. The Ministers and Governors discussed the issues related to the Eighth General Review of Quotas. They agreed that a substantial overall increase was called for. They also recognized the need for a meaningful adjustment of quota shares in the Fund to bring these more in line with the relative position of member countries in the world economy.

8. The Ministers and Governors noted that substantial progress had been made on the Quota Review issues, and were of the view that the conditions were now present for reaching conclusions at the forthcoming meeting of the Interim Committee on February 10-11, 1983. They emphasized the desirability of having new quotas in effect by the end of 1983.

9. The Ministers and Governors expressed their gratitude to the French authorities for their cordial hospitality and for the excellent meeting arrangements.

Attachment

ATTACHMENT

GAB Credit Commitments for G-10 Countries and Switzerland

	In millions of SDRs	Shares in per cent
United States	4,250.0	25.00
Germany	2,380.0	14.00
Japan	2,125.0	12.50
France	1,700.0	10.00
United Kingdom	1,700.0	10.00
Italy	1,105.0	6.50
Canada	892.5	5.25
Netherlands	850.0	5.00
Belgium	595.0	3.50
Sweden	382.5	2.25
Switzerland	1,020.0	6.00
Total	17,000.0	100.00

ANNEX B

IMF Drawings by the United States

The United States has drawn on the International Monetary Fund (IMF) on twenty-four occasions over the past 19 years for a total of about SDR 5.8 billion (equivalent to about $6.5 billion at the exchange rates prevailing at the time of each drawing), the second largest amount of cumulative drawings of any IMF member. None of these drawings were subject to IMF policy conditionality, as they involved drawings on the U.S. reserve position in the IMF. Drawings on the reserve position are available automatically upon representation of balance of payments need; do not bear interest and are not subject to repurchase obligations; and do not involve policy conditionality.

The U.S. drawings were for the following purposes: during the 1960's and early 1970's they were designed to limit foreign purchases of U.S. gold reserves; subsequently, they were designed to provide the United States with foreign currencies for the purpose of exchange market operations. These purposes are explained below. A table listing all U.S. drawings is attached.

Drawings During the 1960's and Early 1970's

Under the international monetary arrangements in operation following World War II, each member of the IMF was required to establish and maintain a "par value" for its currency in terms of gold. The United States undertook to fulfill its par value obligations by standing ready to convert dollars held by foreign monetary authorities into gold at the official price of $35 per ounce -- i.e., the par value of the dollar. Other countries met their par value obligations by maintaining exchange rates for their currencies -- directly or indirectly -- in terms of the dollar within narrow margins. In this manner, a structure of currency exchange rates linked to gold was established and maintained.

During the 1950's and 1960's, large payments imbalances, substantial losses of U.S. gold and foreign accumulations of dollar holdings, representing further potential strains on U.S. gold, put increasing strain on this system. Beginning in the early 1960's the United States, in cooperation with foreign monetary authorities, initiated a variety of measures designed to limit pressures on U.S. gold holdings. U.S. drawings on the IMF were an integral part of this program.

In general, IMF drawings provided the United States with foreign currencies that could be used to purchase dollars from foreign monetary authorities and thus reduce demands for conversion of official dollar holdings to gold. The foreign currencies obtained from the IMF were used most often in the following types of transactions:

- -- to facilitate repayment of IMF drawings by other countries without necessitating use of U.S. gold;
- -- repayment of U.S. short-term currency swaps with foreign central banks; and
- -- direct purchases by the United States of foreign official dollar holdings that would otherwise be used to purchase U.S. gold.

Drawings Since the Early 1970's

With the end of the par value/gold convertibility arrangements in the early 1970's, the basic purpose of U.S. drawings from the IMF was to finance U.S. intervention in the exchange markets in support of the dollar. During the 1970's, the U.S. intervened directly in the foreign exchange market, buying and selling foreign currencies for dollars, in order to deal with exchange market pressures on the dollar. The foreign currencies obtained from U.S. drawings in the IMF provided an important source of funds for such intervention. In November 1978, a U.S. drawing of $3 billion of German marks and Japanese yen was a component of a major program of U.S. and foreign intervention in the exchange market to support the dollar.

IMF Drawings by the United States
(SDR Millions)

Date		Amount	Date		Amount
1964:	Feb	125	1968:	March	200
	June	125		Total	200
	Sept	150			
	Dec	125	1970:	May	150
	Total	525		Total	150
1965	March	75	1971:	Jan	250
	July	300		June	250
	Sept	60		Aug	862
	Total	435		Total	1,362
1966	Jan	100	1972:	April	200
	March	60		Total	200
	April	30			
	May	30	1978:	Nov	2,275
	July	71		Total	2,275
	Aug	282			
	Sept	35			
	Oct	31			
	Nov	12			
	Dec	30			
	Total	681	Grand Total		5,828 [1/]

[1/] Equivalent to about $6.5 billion at exchange rates prevailing at the time of each drawing.

ANNEX C

Budgetary and Accounting Treatment of Transactions with the IMF under the U.S. Quota in the IMF and U.S. Loans to the IMF

Under budget and accounting procedures established in consultations with the Congress at the time of the 1980 increase in the U.S. IMF quota, an increase in the U.S. quota or line of credit to the IMF requires budget authorization and appropriation for the full amount of increases in the quota or U.S. lending arrangements. The sum is included in the budget authority totals for the fiscal year requested. Payment to the IMF of the increased quota subcription is made partly (25 percent) in reserve assets (SDRs or foreign currencies) and partly in non-interest bearing letters of credit, which are a contingent liability. Under the credit lines established pursuant to IMF borrowing arrangements with the United States, the Treasury is committed to provide funds upon call by the IMF.

A budget expenditure occurs only as cash is actually transferred to the IMF, through the 25 percent reserve asset payment, through encashment of the quota letter of credit, or against the borrowing arrangements. Simultaneous with such transfers, the U.S. receives an equal offsetting receipt, representing an increase in the U.S. reserve position in the IMF -- an interest-bearing, liquid international monetary asset that is available unconditionally to the United States in case of balance of payments need. As a consequence of these offsetting transactions, transfers to the IMF under the quota subscription or U.S. lending arrangements therefore do not result in net budget outlays, or directly affect the budget deficit. Similarly, payments of dollars by the IMF to the United States (for example, resulting from repayments by other IMF member countries) do not result in net budget receipts since the U.S. reserve position declines simultaneously by a like amount.

Transfers from the United States to the IMF under the U.S. quota or U.S. lending arrangements increase Treasury borrowing requirements, while transfers from the IMF to the United States improve Treasury's cash position and reduce the borrowing requirement. The net effect of transfers to and from the IMF has varied widely over the years, resulting in cash outflows from the Treasury in some years and inflows to the Treasury in other years. Moreover, Treasury interest costs on borrowings to finance any net transfers to the IMF need to be balanced against the remuneration (interest) earned on the U.S. reserve position in the IMF. Finally, the U.S. may incur exchange gains and losses on the U.S. reserve position in the IMF due to changes in the dollar value of the SDR.

It is not possible to project the effect on Treasury borrowing requirements or the net cost of U.S. transactions with the IMF because of uncertainties regarding the future level of IMF financing; the portion of such financing that would be in dollars; and movements in market interest and exchange rates. However, the figures in the attached table indicate that for the period from May 1, 1969 to the end of 1982:

- -- Net increases in Treasury borrowing requirements attributable to transactions with the IMF averaged $454 million annually, compared to average annual increases in Federal borrowing of $54 billion.
- -- Treasury debt outstanding attributable to transactions with the IMF averaged $1.6 billion annually. This is not an annual increase in Treasury borrowing, but an estimate of the average total debt outstanding each year attributable to cumulative U.S. transactions with the IMF. As of December 31, 1982, the outstanding borrowing attributable to such transactions amounted to $6.3 billion, about 1/2 of 1 percent of the total outstanding Treasury debt of $1.2 trillion.
- -- Net interest costs to the Treasury associated with all U.S. transactions with the IMF averaged $42 million annually. In fiscal 1982, interest costs on total Treasury debt amounted to $117 billion.
- -- Net valuation losses to the U.S. on the U.S. reserve position in the IMF averaged $69 million.
- -- The overall net annual cost to the U.S., taking account of interest and valuation, thus averaged $111 million.

Estimated Gains and Losses Associated With U.S. Transactions Under U.S. Quota and U.S. Loans to IMF

(millions of dollars)

Year Ended April 30 1/	Cumulative Net Treasury Debt(-) or Cash(+) Position Arising From: Transactions Under U.S. Quota 2/ (1)	U.S. Loans to IMF 3/ (2)	Total 4/ (3)	Borrowing Cost(-) or Reduction(+) from Column(3) 5/ (4)	Interest Received by U.S. on Loans to IMF 6/ (5)	Remuneration Received by U.S. from IMF 7/ (6)	Valuation Gains(+) or Losses(-) on U.S. Reserve Position 8/ (7)	Interest Earned on Holdings of Foreign Currencies Drawn from IMF 9/ (8)	Total Net Gains(+) or Losses(-) 10/ (9)
1970	-716	-	-716	-50	-	+13	-	-	-37
1971	-702	-	-702	-38	-	+12	-	-	-26
1972	+445	-	+445	+19	-	*	-	-	+19
1973	+811	-	+811	+39	-	-	+34	-	+73
1974	+704	-	+704	+54	-	-	+54	-	+108
1975	-300	-	-300	-22	-	*	+70	-	+48
1976	-940	-	-940	-52	-	+9	-182	-	-225
1977	-2,695	-131	-2,826	-138	+3	+79	+54	-	-2
1978	-2,726	-639	-3,365	-197	+26	+79	+219	-	+127
1979	-1,368	-329	-1,697	-140	+28	+30	+223	+25	+166
1980	-555	-16	-571	-65	-	-	+15	+46	-4
1981	-1,294	-334	-1,628	-192	+16	+22	-203	+63	-294
1982	-3,416	-862	-4,278	-581	+88	+216	-1,134	+75	-1,336
1983 thru 12/31/82	-5,092	-1,216	-6,308	-364	+64	+222	-94	+39	-133
Total Period: 5/1/69-12/31/82	-17,844	-3,527	-21,371	-1,727	+225	+682	-944	+248	-1,516
Annual Average	-1,306	-258	-1,564	-126	+16	+50	-69	+18	-111

Footnotes

*Indicates less than $500,000.

1/ Represents IMF fiscal year.

2/ Includes U.S. transfers of dollars to the IMF (i.e., an outflow of dollars from Treasury) and dollar balances received by the U.S. from the IMF and from sales of foreign currency drawn by the U.S. from the IMF (i.e., an inflow of dollars to the Treasury).

3/ Includes U.S. loans and repayments under the IMF's General Arrangements to Borrow and Supplementary Financing Facility.

4/ Transfers to and from the IMF under the U.S. quota subscription or U.S. lending arrangements result in budget outlays and simultaneous receipts of U.S. reserve position in the IMF; these transactions have a zero effect on net outlays and the budget deficit.

5/ Equals column 3 times average Treasury 3-month bill rate during period. Payments enter the U.S. budget as interest on the public debt; inflows reduce Treasury's need to borrow and thus reduce interest expense.

6/ Enters the U.S. budget as a receipt.

7/ Remuneration on U.S. creditor position; prior to 1975, remuneration was 1.5%, although special income distributions were made in 1970 and 1971 which raised the effective rate to 2.0 percent in those years. From 1975, the rate was based on short-term market interest rates in the five largest IMF members (U.S., U.K., Germany, France, Japan). Enters the U.S. budget as a receipt. Payments are made by IMF annually, as of April 30; FY 1983 figure represents net accrual as of December 31, 1982.

8/ Reflects changes in the dollar value of the U.S. reserve position in the IMF due to an appreciation (-) or depreciation (+) of the dollar in terms of the SDR. Enters the U.S. budget as a positive or negative net outlay.

9/ Interest earned on investments of German marks and Japanese yen acquired from U.S. drawing on IMF in November 1978. Enters the U.S. budget as part of the net profit or loss of the Exchange Stabilization Fund of the Treasury, recorded as a positive or negative net outlay.

10/ Equal to the sum of columns 4 through 8.

SECRETARY REGAN'S RESPONSE TO QUESTIONS OF SENATOR HEINZ

Question 1:

What economic growth in the developed countries will be necessary to ensure that the LDCs will have the export earnings to pay-off or even service their debt?

Answer:

There is no economic growth rate for the developed countries which can, by itself, ensure that the LDCs will avoid debt problems. A major element of the solution to LDC debt service problems is the establishment of economic conditions within the LDCs themselves which will foster efficient allocation of resources, improve their export potential, and create a climate conducive to import substitution. Growth in the industrial countries is an important part of the environment needed for resolution of the debt situation, but the effort needs to be broader. Faster growing exports will, of course, provide growing foreign currency earnings which can be used to service debt. But it is equally important that LDCs implement appropriate domestic macroeconomic policies which will both restrain the growth of their imports, their current account deficits, and hence their external debt, and assure that the external borrowings are invested efficiently.

Question 2:

If you favor a country lending limit by U.S. banks, what level would be appropriate, how could it be established, monitored, and enforced?

Answer:

I do not favor a specific country limit.

In the case of a uniform limit for all banks -- defined, for example, as a percentage of bank capital -- the problem would not be in monitoring or enforcing a decision, which in principle could be made within the existing interagency framework of the bank regulators. Rather, the problem would lie in the concept itself and in the difficulty, if not impossibility, of determining what the appropriate level is. Different banks have different interests and abilities to lend to different countries. A limit that did not distinguish among countries would be particularly arbitrary, but one that did attempt to vary the rate according to relative ability to service debt would risk being capricious, and at a minimum would be highly controversial, subjecting the decision-making apparatus to a cross-current of foreign and domestic pressures.

A series of specific limits which varied bank-to-bank would diminish some of the rigidity but would retain all the other disadvantages. In addition, such a scheme would be extremely complex, particularly if limits also varied country-to-country.

In sum, country limits, whether established by law or regulation, appear to be neither desirable nor feasible. We should instead look toward strengthening the existing system of monitoring and appraising concentrations of country risk, and possibly towards other regulatory tools such as prudential reserves against concentrations identified as excessive.

Question 3:

Is there any indication that U.S. banks are changing their cross-border lending policies? How?

Answer:

U.S. banks have pulled back sharply from lending to developing countries since mid-1982. We expect only a modest increase in claims outstanding during 1983 compared to growth rates of around 20 percent from 1979 to mid-1982. A significant part of this growth will be lending associated with IMF adjustment programs.

It remains to be seen whether and to what extent the increased caution now being exercised will change. Much will depend on the success of the adjustment policies being pursued by the countries experiencing debt servicing difficulties and on the vigor of economic recovery. It seems unlikely that banks will revert to the lending growth rates that characterized the 1979 to mid-1982 period. Nevertheless, the Treasury and the bank regulatory agencies are considering how best to adapt the regulatory process to ensure that future growth in foreign lending remains at prudent levels.

Question 4:

Given all the publicity about the tremendous debt owed to American banks by LDCs and their ability to repay, is there any evidence to suggest that American bank depositors are losing confidence in American banks?

Answer:

No. The U.S. banking system remains fundamentally sound. A few large U.S. banks which are active in international lending have on occasion experienced reduced acceptability for their certificates of deposit, but these market reactions appear to have been largely if not entirely a reflection of an increased volume of problem loans in their domestic portfolios.

Question 5:

Some bankers claim that the U.S. Government encouraged them to get into balance-of-payments type lending in the 1970s in order to "recycle" the "petrodollars" resulting from the two oil shocks. Have you seen any evidence that this was actively done?

Answer:

In general, the major role of the private market in international lending was viewed as necessary and desirable in dealing with the aftermath of the oil price increases.

The oil price increases of 1973/74 and 1979/80 resulted in major shifts in international payments patterns and a substantial increase in external financing requirements. Initially, there was widespread concern that the pattern of OPEC placements would not correspond to the distribution of enlarged current account deficits, and that intermediation on an unprecedented scale would be required. In particular, it was feared that this "recycling" process would not work smoothly and that some countries would be forced to undertake abrupt and disruptive adjustment measures due to lack of sufficient financing.

There was broad recognition that the private markets would have to handle the bulk of the intermediation. (See, for example, NAC special reports in 1975 to 1977 and 1979, and statements by senior Treasury officials throughout the period.) Most of the OPEC funds were placed initially in the private markets, primarily in short- to medium-term deposits in commercial banks. Moreover, only the private markets had the resources, expertise and institutional capacity to perform the recycling function smoothly. Consequently, while the amount of official financing expanded in absolute terms, the private markets provided most of the increased financing.

From 1976 to 1982, the private markets provided about 71 percent of total financing needs of deficit countries. Official sources accounted for about 26 percent (of which the IMF represented 2 percent), and the remaining 3 percent is unexplained. The ability of the private markets, particularly the commercial banking system, to respond flexibly and effectively was a major factor in the ability of the system to deal with a difficult situation. However, the counterpart has been an enormous increase in indebtedness which for some countries is no longer sustainable at a time of changed economic conditions.

Question 6:

Should banks be allowed to collect fees and higher interest rates when rescheduling loans?

Answer:

Fees and interest rate spreads should be determined by market forces. If a country's creditworthiness deteriorates, it should expect to pay a higher rate.

There are questions, however, about the appropriate accounting treatment for that portion of fees which in effect represents an upward adjustment of interest yield. At present, there are no clear guidelines on the treatment of fee income from either the Financial Accounting Standards Board, the Institute of Certified Public Accountants, the Bank Audit Guide or the federal bank regulatory agencies. These agencies have testified recently that they are exploring guidelines that they might issue to help resolve questions which have been raised about the appropriate accounting treatment of fee income.

Question 7:

What are the economic advantages and disadvantages of the proposal to require banks to convert short-term loans to long-term loans and reduce the interest rate? How would this affect interest payments of countries such as Mexico and Brazil? Would this proposal encourage borrowing countries to delay debt servicing payments in order to benefit from restructuring?

Answer:

Proposals of this nature could potentially reduce uncertainty, since the threat of a default situation would be postponed. However such proposals present several disadvantages.

While easier terms would provide more time for debtors such as Mexico and Brazil to undertake necessary adjustments in their economic policies, they would also create an incentive for postponing or even avoiding entirely such adjustments, and to encourage overborrowing in the future. This effect would be a significant disadvantage.

In addition, significant costs would be involved in a conversion of debt from a market to a below-market interest rate, presumably at a fixed level rather than on a floating basis. Depending on the rate chosen, the proposal could involve a substantial loss to the banks. While banks should not be protected from the consequences of their lending decisions, it does not seem appropriate to try to force on the banks a particular restructuring of their loans. In such an event, they would undoubtedly look to governments to compensate them for their losses.

Other considerations include the immense practical difficulties that would be involved in determining which debtor countries should be covered, what the specific terms would be, and how to ensure comparable treatment of all banks. Also, if only U.S. banks were involved, they would be disadvantaged vis-a-vis foreign banks.

Question 8:

One current proposal is that an international agency (possibly within the IMF) or governments of industrial countries buy the short-term bank loans to developing countries at a discount and replace them with long-term loans at lower interest rates. What are the advantages and disadvantages of such a proposal?

Answer:

Such a proposal is similar in some respects to the one raised in the previous question. Many of the disadvantages are the same. In addition, it would result in assumption by the agency -- i.e., by governments -- of a number of dubious loans and have most if not all the characteristics of a bailout.

INTERNATIONAL DEBT

TUESDAY, FEBRUARY 15, 1983

U.S. SENATE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, D.C.

The subcommittee met at 9:40 a.m., in room SD-538 of the Dirksen Senate Office Building; Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Proxmire, and Lautenberg.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Today the subcommittee will hold the second of its hearings on the international monetary situation in general and on participation of the United States in the IMF, in particular.

Yesterday afternoon the subcommittee received testimony from Treasury Secretary Donald Regan. Today we are going to hear from Under Secretary of Commerce for International Affairs, Lionel Olmer.

Clearly, international finance is at the heart of international trade, and increasingly, in the last few years, international trade has become directly involved in our own economic well-being. Mr. Olmer's testimony should help us understand more clearly just how closely connected the international debt crisis is with our economic health in this country.

I gave as my view yesterday, to which Secretary Regan agreed, that the swift and effective resolution of the current debt crisis is essential to our welfare and future economic growth. As I also stated, it is my conviction that the current situation would not have been in this crisis, had our Nation's banks acted more conservatively and more prudently.

In order to explore this problem more thoroughly, we've invited to testify this morning, Mr. George Champion, former chief executive officer of Chase Manhattan Bank, Mr. Martin P. Mayer, whose book, "The Bankers," was one of the best sellers on the banking industry.

Both of you gentlemen have expressed important criticism on the role of U.S. commercial banks in the present crisis.

Finally, we'll conclude this morning's hearing with a panel with representatives of two of the Nation's prestigious commercial banks and a representative of the Chamber of Commerce, all of which have been active participants in international lending.

Let me just add, it seems clear to me from yesterday's hearings, as well as from discussion with my colleagues, that this committee is sympathetic to the need to increase the resources of the International Monetary Fund, but as I and a few others stated yesterday, that doesn't necessarily mean this committee will avoid taking the necessary steps to reduce the likelihood of the recurrence of the current precarious financial situation. The testimony received yesterday and yet to be received today in today's hearings and at the hearings this Thursday when Chairman Volcker will be joined by the Comptroller of the Currency Conover and FDIC Chairman Bill Isaac, will be essential to our deliberation as to just what remedies are, indeed, necessary.

Before I call Mr. Olmer, I would like to yield to my colleague and friend, Bill Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Mr. Chairman, I want to congratulate you on the way you've conducted these hearings. Also on the witnesses we've had to date, I thought Treasury Secretary Regan did a very find job yesterday. I might say that I have sat through 3 days of hearings in the Foreign Relations Committee and heard about a score of witnesses. We heard Mr. Sprinkel come up and testify. The problem here is, I think we're being sold a blind date as a kind of Miss America. Actually, this girl is fat, has freckles and ought to brush her teeth a little bit more. This really isn't a very attractive action we're going to have to take, and we ought to face—look at all the warts on the body we're going to have to [Laughter.] The body we're going to have to deal with, because, believe me, she has freckles, and she's fat.

Senator **Heinz**. Will Senator Proxmire yield?

Senator **Proxmire**. I yield.

Senator **Heinz**. Are you suggesting cosmetic surgery?

Senator **Proxmire**. Maybe we have to do a little bit of that. But the reason I say this is because we have to recognize the IMF is going to have to take $8.4 billion in borrowing out of our economy at a time when we have colossal deficits. It's going to have to make conditions on which the banks would lend more than they would have otherwise, which takes even more out of the economy, at a time when we need that kind of assistance. And it's going to have to make conditions with the borrowing countries, that they will reduce their imports at least for a while. That's the one thing they can do. They can't do much about their exports consciously to reduce their imports, so they can bring their balance of payments into better balance.

So this is something that's going to be at least a mix—I was going to say a mixed bag. It's going to be mixed. [Laughter.]

And I think we have to be aware of the problems that confront us. And I think that the Chairman certainly is able to do this.

Senator **Heinz**. Thank you, Senator.

Senator **Proxmire**. I apologize.

Senator **Heinz**. I want you to know that is one of the most extended metaphors that I ever heard, since we took up the Foreign Corrupt Practices Act.

Whereas I recollect the chairman had some choice words about some legislation before us, where the then-chairman accused the administration, as I think it was, of hanging, drawing, quartering, and scattering to the four winds the basic underlying principles of the Foreign Corrupt Practices Act, I seem to recollect that that act finally passed the Senate unanimously, which causes me to observe that ugliness, like beauty, is only skin deep.

Senator **Proxmire**. Mr. Chairman, I want to apologize. You'll be glad to know I'm going to have to leave in about 10 minutes, but I will get back here if I possibly can. [Laughter.]

Senator **Heinz**. Secretary Olmer.

STATEMENT LIONEL OLMER, UNDER SECRETARY FOR INTERNATIONAL TRADE, DEPARTMENT OF COMMERCE

Mr. **Olmer**. Thank you, Mr. Chairman, Senator Proxmire. I'm very pleased to be here. I have a somewhat extended statement for the record, which I would like to summarize right now.

Senator Proxmire's description of this being a mixed bag is quite apt, because it does seem to me that most of the attention thus far has defined the problem in terms of debits and credits, something for the banks and the countries in the developing world to work out with the support of international assistance agencies. But it is not merely a financial problem; it is also a trade problem of growing seriousness. I don't think we can have a resolution or an understanding of how one reaches a resolution, until we recognize the problem involved in its many manifestations.

A number of LDC's who have accumulated large amounts of debt are currently unable to attract capital inflows or run the current account surpluses necessary to service this debt.

Many banks are heavily exposed to developing LDCs and some would like to reduce exposure by reducing new lending. If that's done before the LDCs can trim their financing needs, the countries will have to make deeper import cuts, even cuts into essential imports or fall further behind in debt repayments. The extent of our financial and trade relations with these countries means that the business community and/or the banking community would assuredly be adversely affected.

TRADE PROBLEMS

The trade area is probably experiencing the most immediate and present effects of the problems in the financial and economic system. We have witnessed very sharp drops in U.S. exports in the last 18 months. U.S. trade to Mexico dropped some 36 percent last year, with the decline accelerating in the latter part of the year. Sales to Argentina were down 40 percent, to Peru, 25 percent and 36 percent for Chile.

This trend stands in sharp contrast with that which has been experienced over the last 10 years, when these countries were part of the fastest growing U.S. export market. Key U.S. exporters had made major inroads, at substantial effort, into LDC markets during that period. Now these same exports are experiencing rapid declines.

If financial constraints increase this year, LDC imports will have to be cut even further. Thus, trade problems and the jobs they represent for American workers are likely to become even more worrisome.

In the area of trade-related financing, we are getting reports of further disruptions, so-called balance of payments or general purpose credits, which LDC's have often used to buy commodities, and other consumables have been curtailed. Medium-term lending to support capital goods exports to high debt LDC's has also been reduced.

Most major international banks appear to be maintaining short-term trade credit facilities to problem LDC's, but the overall volume of this type of credit is down sharply from last July. Banks appear to be confining short-term export credits to deals which benefit long-standing domestic corporate clients, or to key customers in LDC's. Thus, new exporters or traders who now want bank financing for their sales are suffering most.

Many exporters are seeking bank cover for sales that have been traditionally concluded without the need for credit. This has placed added pressure on financing of U.S. lending and international trade, since banks are unwilling or unable to increase lending to accommodate the influx of new requests for credit.

COUNTERTRADE AND BARTER

Because of the convergence of growing debt, worldwide recession and resulting liquidity problems, a substantial worldwide upsurge in countertrade and barter is occurring.

Major trading companies are inevitably moving towards barter as a means of maintaining trade relations. Estimates of the total amount of countertrade and barter are rough, but Chase Manhattan has asserted that between one-fourth and one-fifth of total world trade is under some form of barter arrangement and that the proportion is rapidly growing.

Countertrade and barter pose significant problems with respect to a multilateral trading system. Foremost is the tendency for countertrade to reinforce bilateralism, and this runs counter to the progress which has been achieved to date in trade liberalization since the end of World War II.

Another factor influencing the relationship between trade and finance is exchange rates and capital flows. In the past, the trade component of the current account had a large amd direct influence on exchange rates. If a country's trade account was in deficit, its currency tended to depreciate, eventually making its exports competitive, improvings its trade account and later the exchange rate.

More recently other factors have offset the effects of trade flows on exchange rates. The dollar has continued to appreciate against the yen and most other OECD currencies. In the last 2 years, we registered surpluses in our current account, despite continued large trade deficits. This is explained partly by growing international capital movements which vastly exceed trade-related currency movements. The result, however, is exchange rates that are not as directly linked as they have historically been to trade.

The situation has hurt U.S. exports and dramatically so. Since 1980, the strength of the dollar has raised the U.S. manufactured goods' trade prices 30 percent relative to our industrialized competitors. Now a 30 percent differential is an almost impossible marketing obstacle to overcome. American companies that have worked for years to establish export marketing and distribution networks overseas are, in many instances, finding their efforts wiped out.

The trade implications of the financial problem have further implications on economic activity. The economic growth in LDC's and in the OECD in the period between 1974 and 1980 was to some extent fueled by the ability of banks to provide the liquidity needed for a rapid growth in trade with LDC's.

In the recent recession, however, the decline in the U.S. external account has been a contributing factor to the decline in the GNP. Roughly, 46 percent of the 2.6 percent drop in the U.S. GNP through the fourth quarter of 1982 can be explained by the deterioration in the U.S. external account. Had our exports of goods and services merely stagnated in the second half of last year, rather than falling sharply as they did, the real U.S. GNP would have risen at an annual rate of 1.8 percent in the second half of the year rather than the .9 percent that actually occurred.

A solid U.S. recovery will be needed to yield a revival in trade. And this will be dependent on the availability of bank and IMF lending. Estimates vary, but sharp reductions in bank lending to LDC's could reduce their imports enough to cut OECD and U.S. GNP by as much as ½ to 1 percent from what it otherwise would have been.

In summary, Mr. Chairman, allowing the necessary adjustments in LDC trade accounts may retard OECD economic recovery, may increase domestic political pressures in key LDC's and increase trade tensions.

On the other hand, increasing financial flows will increase bank exposure, add to LDC debt burdens and may delay the adjustment in LDC economies needed to resolve the debt dilemma.

APPROACHES TO CURRENT PROBLEMS

The following, in my judgment, should be included in our approaches to the current problems:

On the financial side, the increase in IMF resources is the minimum necessary to meet the current liquidity problems. The IMF is the only institution that can ensure prudent adjustment in the LDC's and adequate lending by private banks. Just the fact that this money is available to avert future crises will assist in stabilizing international markets and should produce essential lending by international banks.

The trade area is probably the first to pick up the "jitters" in the financial system and the ensuing contractions affect U.S. economic activity and the credit available to domestic exporters. If we are going to move toward long-term stability in financial markets, the increase in IMF resources has to be the first step.

We also need to assure that financial problems do not cause unnecessary disruptions in the free market for goods. The GATT balance of payments committee reviews the measures taken by the countries to meet IMF trade adjustment goals and does seek to phase out trade restrictive measures as quickly as possible.

We need to see greater coordination between the IMF and the GATT.

In the area of trade finance, we have made certain that the financial packages put together for a number of countries include export credits, thus ensuring that U.S. loans will assist U.S. exporters. Given the growing problem in trade financing, we are also proposing that $10 billion in Eximbank guarantees be part of this year's Eximbank authorization.

On countertrade, we are responding on two fronts. First, we are discussing these matters in bilateral consultations in the OECD, the U.N. and the GATT.

While we do not encourage the practice, we find it necesssary to provide practical advice to U.S. firms, lest they lose their markets. An idealized view of a multilateral trading system should not interfere with the pragmatic need to assist U.S. exporters in the real world they confront.

The Commerce Department has initiated educational seminars for American companies. Last month in Miami a seminar was held for our foreign commercial officers stationed throughout Latin America. That seminar provided information, not only on commerce and barter, but on the export trading company legislation signed into law by the President last year. Hopefully, that law will put U.S. companies in a much stronger position to protect and expand U.S. market shares where countertrade practices most often take place.

We are also examining ways in which countertrade can be made more visible among exporting nations so as to develop maximum conformity with accepted international trade rules and to reduce the chances for buyers to play one supplier against another.

The third side of the triangle of problems is the economic one. Fortunately, the U.S. economy is beginning the long awaited recovery. The U.S. alone cannot fuel a global recovery and we must work to assure that OECD economies also revive. LDC imports are an important element in OECD GNP and almost all analysts agree that global noninflationary growth is essential, if the debt and trade problems are to be overcome.

Mr. Chairman, in short, trade protectionism has to be resisted not just for the usual reasons associated with free trade, but for the viability of the international financial and economic systems so painfully constructed since 1945.

The program which Secretary Regan briefed you on yesterday, we believe puts the administration in the direction of moving forward.

Thank you, Mr. Chairman.

[Complete statement follows:]

Statement of

Lionel H. Olmer
Under Secretary for International Trade
U. S. Department of Commerce

Mr. Chairman and members of the committee:

I am pleased to have the opportunity to meet with you today to discuss current problems in the world's financial system which are having and will have a major impact on international trade.

Most of the attention thus far has defined the problem in terms of debits and credits, something for the banks and the countries in the developing world to work out with the support of international assistance agencies. But it is not merely a financial problem; it is also a trade problem of growing seriousness. Reaching a comprehensive understanding of the trade, economic and financial aspects is crucial to finding long term solutions.

I would like to illustrate the interrelated nature of this issue focusing in detail on the pressures building on the trading system.

Finance

The borrowing of LDCs, which has grown dramatically since the first oil shock over 9 years ago, was for a time offset by increasing economic growth and expanding exports . It allowed for a rapid increase in U.S. exports to these countries, and strong growth in the LDC and OECD economies. However, this borrowing was also a way for some countries to postpone adjustment to the first oil shock as a combination of increasing export earnings, low interest rates and high inflation kept real debt burdens manageable.

After the second oil shock of 1979 and the beginning of the current world recession the situation in many LDCs took a dramatic turn for the worse. Interest rates rose worldwide, yet most LDCs attempted to avoid adjustment by increasing short term borrowing. A declining demand for exports and an outright drop in export prices (primarily commodities) left LDC export earnings in 1982 unchanged from 1980 levels. With rising real interest rates, short term debt growing rapidly and export earnings flat or declining, banks became unwilling or unable to maintain the pace of lending required to sustain the debt service of key LDCs.

Many LDCs who have accumulated large amounts of debt are currently unable to attract capital inflows or run the current account surpluses necessary to service this debt. At this stage of development many LDCs cannot be expected to be net exporters. The U.S was in a similar stage of development in the late 1800s. U.S. current account deficits averaged close to 25% of total exports. External debt averaged over 300% of exports between 1885 and 1890 and interest costs ranged between 10 and 15% of exports. These ratios were well above those recorded by most LDCs over the last two decades. Had our creditors gotten cold feet during that period the U.S. economy might not have developed as rapidly as it did and decisions made in this chamber and in the U.S banking community today might not be so crucial to the world economy.

These decisions are crucial, however, and we should recognize the global implications of the policies we choose in addressing the current problems. Many banks are heavily exposed to developing LDCs and some would like to reduce exposure to these countries by reducing new lending. However, if this is done before LDCs can trim their financing needs, the countries will have to make further deep import cuts, even cuts into essential imports, or fall behind in debt repayments. The extent of our financial and trade relations with these countries means that the business community and/or the banking community would be adversely affected.

Trade

The trade area is probably experiencing the most immediate effects of the problems in the financial and economic systems. We have witnessed sharp drops in U.S. exports in the last 18 months. U.S. trade to Mexico dropped 36% in 1982 with the decline accelerating in the latter part of the year. Sales to Argentina were down 40%, to Peru, 25% and Chile 36%.

This trend stands in sharp contrast with the trend over the last 10 years, when these countries were part of the fastest growing U.S. export market. The LDC's share of U.S. manufactured exports grew from 29% to 39% of the total U.S. exports of these goods between 1970 and 1980. Key U.S. exporters had made major inroads into LDC markets during the period. Now these same exporters are experiencing rapid declines. I have attached some examples of the extent of this decline and I ask that you enter them into the record.

Let me briefly cover the situation in Mexico, our third largest trading partner.

- Cereal and preparation exports had increased by more than 200% between 1978-81 and were down 71% last year;
- Transportation Equipment (except road vehicles) up over 600% between 1978-81, down 71%;
- Iron and Steel, up over 200% in these 3 years were down 58% last year;
- Manufactures of metals, up 354% from 1978-1981, down 52%.

The overall decline in exports to Mexico alone was $6.3 billion.

If financial constraints increase this year, LDC imports will have to be cut even further; thus, trade problems and the jobs they represent for American workers are likely to become even more worrisome.

In the area of trade-related financing we are getting reports of further disruptions. While it is difficult to collect precise data on trade financing activities, we have recent reports from bankers and trading companies along the following lines:

- So-called "balance of payments" or "general purpose" credits which LDCs often use to buy commodities and other consumables have been curtailed. Medium-term lending to support capital goods exports to high debt LDCs has also been reduced, but at this stage it is impossible to determine exactly to what degree.

- Most major internatonal banks in the U.S., Europe, and Asia appear to be maintaining short-term trade credit facilities to problem LDCs, but the overall volume of this type of credit appears to be down sharply from last July's level (i.e., prior to the Mexican crisis). Banks appear to be confining short-term export credit to deals which benefit long-standing domestic corporate clients, or to key customers in LDCs, and for products which are essential for the functioning of LDC economies. New exporters or traders who now want bank financing for their sales are suffering most.

- In conducting business with some countries, many exporters are seeking bank cover for sales that have traditionally been concluded without the need for credit. This has placed added pressure on the financing of U.S. and international trade, since banks are unwilling or unable to increase lending to accommodate the influx of new requests for credit. As a result, a trade financing gap has developed which could produce an unplanned constraint on OECD-LDC trade for some time to come and make the availability of finance the major factor in export sales.

Because of the convergence of growing debt, worldwide recession, and resulting liquidity problems, a substantial worldwide upsurge in countertrade is occurring. Saddled with inadequate export marketing networks, with protection growing in some markets, with lagging demand for exports and a shortage of hard currency, non-market economies and developing countries have turned to countertrade practices as a means of restoring their trade balances, to redress external debts, to maintain employment levels and hopefully to find markets for their exports.

Major trading companies faced with the contraction in trade finance report that they are inevitably moving towards barter as a means of maintaining trade relations. But barter is a voluntary arrangement and should be distinguished from countertrade.

In essence, countertrade is a form of reciprocal, conditional or linked trade involving a requirement to purchase as a condition for sales to a particular country.

Estimates of the total amount of countertrade and barter are rough at best. However, a recent assessment by the Chase Manhattan Bank's Trade Information Corporation asserts that between one-fourth to one-fifth of total world trade is under some form of barter and that the proportion is rapidly growing.

While countertrade, particularly in this time of world recession, could be viewed as having the advantage of creating trade which might otherwise not exist or at least mitigating the impact of shrinking trade flows amidst the debt crisis, it poses significant problems with respect to our multilateral trading system.

Foremost among the problems is the tendency for countertrade to reinforce bilateralism, and this runs counter to progress achieved in trade liberalization since 1945.

One other factor influencing the interrelationship between trade and finance is exchange rates and capital flows. In the past the trade component of the current account had a large direct influence on exchange rates. If a country's trade account was in deficit, its currency tended to depreciate, eventually making its exports competitive, improving its trade account and later the exchange rate. More recently other factors have, for a time, offset the effects of trade flows on exchange rates. The dollar has continued to appreciate against the yen and most other OECD currencies as over the last two years we registered surpluses in our current account despite continued large trade deficits. This changing relationship between trade and exchange rates is explained by growing international capital movements which vastly exceeded trade related currency movements as high interest rates caused demand for dollar assets and the dollar itself to rise. The result is exchange rates that were not as directly linked to trade.

This has hurt U.S. exports. Since 1980 the strength of the dollar has raised U.S. manufactured goods' trade prices 30 percent relative to our industrialized competitors. A 30 percent differential is a difficult marketing obstacle to overcome. American companies that have worked for years to establish export marketing and distribution networks overseas are, in many instances, finding their efforts wiped out by a sudden inability to compete because of the strength of the dollar.

Exchange rates have not only affected trade, they have also affected the international financial situation. Latin American countries' that pegged their currencies to the dollar initially found their competitiveness deteriorate as the dollar climbed, just when the opposite result was required. Many substituted protectionist policies and subsidies to protect their trade balance. Eventually most have had to devalue, raising the domestic currency cost of their debt repayments and their imports, while increasing domestic inflation.

Economic

The trade implications of the financial problem have further implications on economic activity. The economic growth in LDCs and in the OECD in the period between 1974-1980 was to some extent fueled by the ability of banks (flush with OPEC deposits) to provide the liquidity needed for a rapid growth in trade with LDCs.

In the recent recession the decline in the U.S. external account has been a contributing factor to a decline in GNP. In fact 46% of the 2.6% drop in U.S. GNP through the fourth quarter of 1982 can be explained by the deterioration in the U.S. external account. Had our exports of goods and services merely stagnated in the second half of last year, rather than falling sharply as they did, U.S. real GNP would have risen at an annual rate of 1.8 percent in the second half of the year -- rather than the 0.9 percent annual rate drop that actually occurred.

A solid U.S. recovery will be needed to yield a revival in trade. However, high-debt LDCs will need to reduce their imports and expand their exports further if they are to meet their debt service payments. The extent to which the trade account will be affected depends on the availability of bank and IMF lending. Estimates vary but sharp reductions in bank lending to LDCs could reduce their imports enough to cut OECD and U.S. GNP by as much as 1/2-1% from what it would otherwise have been.

This presents us with an economic double-bind. LDCs' ability to recover and service debt will ultimately depend on an increase in exports after an initial decrease in imports. This will come predominately as the result of recovery in major markets in the OECD. Pressures in the OECD are building to restrict imports and to increase our exports and LDCs have been a major market for export growth. There is no way we all can increase exports without imports increasing also and there can be no long term global recovery without initial export expansion. Unfortunately, the recession, unemployment, and debt burdens are leading governments to look to self-defeating policies of import reductions and export expansion as a solution to their problems.

Political

The dilemmas facing us in finance, economics and trade will be difficult to resolve because they are backed by significant political pressures. Political pressures in the 1970s led to inflationary policies and slowed the needed adjustments in LDC economies. The steps that need to be taken now will be all the more difficult because those decisions were not taken earlier. However, the options are now fewer and the pressures greater. Both in developed countries and in LDCs there will be strong resistance to the actions that are necessary if we are to extract ourselves from this situation and move on a path toward long-term growth.

In many LDCs the adjustments that are required will cost much in the way of political and economic sacrifice. Where population growth exceeds economic growth, political pressures will build. OECD creditors may become the scapegoats for those who choose to blame the banks for their troubles and who are unprepared to implement necessary adjustment policies.

Pressures in the OECD will build to stop lending to these countries and to prevent an influx of LDC imports. With 32 million people unemployed in the industrial world, using tight money to buy LDC imports or to finance their debt will not be popular. The political double-bind will come as pressures build in the OECD to stop lending to LDCs and to slow importing, while in the LDCs, leaders may be pushed to further extend their debt and to move to new markets for trade.

Conclusions

I hope that this review of the financial, trade, economic and political situation illustrates the complexity of the problem we face: Allowing the necessary adjustments in LDC trade accounts may retard OECD economic recovery, increase domestic political pressures in key LDCs and increase trade tensions; on the other hand, increasing financial flows will increase bank exposure, add to LDC debt burdens and may delay the adjustment in LDC economies needed to resolve the debt dilemma. In addressing this problem, it is obvious that decisions taken on financial policies have trade and economic policy.

I believe the following should be included in approaches to the current problems:

Finance

On the financial side, the increase in IMF resources is the minimum necessary to meet the current liquidity problems. The IMF is the only institution that can ensure prudent adjustment in the LDCs and adequate lending by private banks. Just the fact that this money is available to avert future crises will assist in stablizing international markets and should produce essential lending by international banks, including restoring confidence to normal trade credit facilities.

This new lending, it should be noted, will come from both U.S. and foreign banks, since U.S. banks account for a little over 1/3 of total banks claims in LDCs. This committee, in considering the extent of U.S. bank participation in international lending, will recognize the multilateral commitments needed to maintain adequate credit lines. While I certainly do not think the banks are faultless in the current situation, their continued involvement is necessary to long term solutions.

As I have pointed out, the trade area is probably the first to pick up "jitters" in the financial system and the ensuing contractions affect U.S. economic activity and the credit available to domestic exporters . If we are to move toward long term stability in financial markets the increase in IMF resources must be the first step.

Trade

In the trade area we need to assure that financial problems do not cause unnecessary disruptions in the free market for goods. We are discussing in multilateral and bilateral meetings, various ways to maintain the openness of markets. The GATT balance of payments committee reviews the measures taken by countries to meet IMF trade adjustment goals and seeks to phase out trade restrictive measures as quickly as possible. We need to seek greater coordination between the IMF and GATT so that the adjustments that take place do not add to protectionist pressures but rather provide some opportunities for trade expansion. As economic recovery takes place, we must move to dismantle the destructive trade barriers built up over the past decade.

In the area of trade finance we have made certain that the financial packages put together for a number of countries include export credits, thus ensuring that U.S. loans assist U.S. exporters. Given the growing problem in trade finance we are also proposing that $10 billion in EXIM bank guarantees be part of this year's EXIM bank authorization. Given the inability for normal channels of trade finance to operate smoothly in this climate, the EXIM bank, FCIA and some private insurers will undoubtably be crucial in preventing an even greater decline in U.S. exports to high-debt LDCs.

On countertrade we are responding on two fronts. First we are discussing these matters in bilateral consultation with several countries (Mexico, Korea, and Indonesia) who support countertrade.

We have also raised issues related to countertrade in the OECD, the UN and the GATT. We have requested that these organizations study and set up a mechanism for consultations so members can present their case and obtain satisfaction if appropriate.

While we do not encourage the practice, we have found it necessary to provide practical advice to U.S firms lest they lose their markets. An idealized view of a multilateral trading system should not interfere with the pragmatic need to assist U.S. exporters in the real world they confront.

Consequently, the Commerce Department has begun seriously to examine the implications of countertrade and barter, and to initiate educational seminars for American companies. Last month in Miami a seminar was held for our foreign commercial officers stationed in Latin America. That seminar also provided information on the export trading company legislation signed into law by the President last year. Fortunately, that law will put U.S. companies in a much stronger position to protect and expand U.S. market shares where countertrade practices most often take place.

We will continue to consider what practical changes in U.S. policies and laws could avoid unnecessary export losses. We will also examine ways in which countertrade can be made more visible among exporting nations so as to develop maximum conformity with accepted international trade rules and to reduce the chances for buyers to play one supplier against another.

Economic

The third side of the triangle of problems is the economic one. Fortunately, the U.S. economy is beginning the long awaited recovery. However, the U.S. alone cannot fuel a global recovery and we must work to assure that OECD economies also revive. A crucial element here is to assure that contractions in financial flows do not throw LDC economies in reverse by halting the essential imports necessary for their economic progress. LDC imports are an important element in OECD GNP and almost all analysts agree that global non-inflationary growth is essential if the debt and trade problems are to be overcome.

Finally, Mr. Chairman, in order to again emphasize how closely related these problems are I would like to summarize the most recent annual report of the GATT.

> "The words "trade war" now appear almost daily in the headlines. This danger should not be over-dramatized. Memories of the 1930s, and the enormous stake which most countries have in a continued flow of goods and services should rule out a sudden, large-scale breakdown in trade relations. The gradual but continuing accumulation of restrictions on international trade of course poses a threat to the multilateral trading system which we must not underestimate, but the more immediate danger may be that it will trigger a severe disturbance in the already troubled international financial system.
>
> This danger was demonstrated in the decade of the Great Depression. Not even today can full agreement be said to exist on all points of the economic history of that unhappy period. The standard explanation has emphasized the central role of the absolute decline (by one-third) in the United States money supply. However, at that stage the collapse of confidence was already far advanced. More recent discussion has identified two factors which can explain how the process started. Firstly, there had been, in the 1920s, a sudden large increase in international indebtedness, most of which was "dead weight debt"(inter-Allied war debt and German reparations). Secondly, diplomatic efforts of the decade had not succeeded in establishing an institutionalized international order capable of preventing a rapid deterioration in the conditions of international trade.
>
> These more recent explanations emphasized that the international financial crisis occurred after the United States Congress passed the highly restrictive Smoot-Hawley Tariff Act in June 1930. The long Congressional deliberations on the Act were followed anxiously by other governments, and when it was signed into law, commercial retaliation by a number of countries followed promptly. As trade declined, a growing proporation of the debts of business depending on export trade, and of foreign debts, became uncollectable. Thus it is not surprising that the United States banking crisis began with runs on banks in the agricultural exporting districts in the Southeast and Midwest of the country.
>
> It is often argued that a shortage of international liquidity leads to protectionism. This brief review of recent history suggests, however, that the danger inherent in the present situation is just the reverse -- that protectionism could cause an international liquidity shortage, one severe enough to produce a series of insolvencies."

In short, trade protectionism has to be resisted not just for the usual reasons associated with free trade but for the viability of the international financial and economic systems so painfully constructed since 1945.

Mr. Chairman, if we are to escape this danger, financial, trade and economic problems must be viewed in an integrated fashion. This Administration is attempting to move in that direction and over the course of this year we look forward to working with this committee in assuring that this approach is successful.

U.S. Trade With Selected Countries in Latin America
(Data in millions of dollars except where noted)

	U.S. Exports*				U.S. Imports*				Balance		
	1981	1982	Change $	Change %	1981	1982	Change $	Change %	1981	1982	Change $
Argentina	2128	1268	-860	-40	1123	1065	-58	-5	1005	202	-803
Brazil	3742	3369	-373	-10	4333	4171	-162	-4	-591	-802	-211
Chile	1436	917	-519	-36	543	669	126	23	893	249	-644
Mexico	17353	11026	-6327	-36	13704	15488	1784	13	3649	-4462	-8111
Peru	1467	1103	-364	-25	1147	1072	-75	-7	320	31	-289
Venezuela	5347	5061	-286	-5	5575	4757	-818	-71	-228	304	532
Total for above 6	31473	22744	-8729	-28	26425	27222	797	3	5048	-4478	-9526
Latin America	40987	32092	-8895	-22	38548	37558	-990	-3	2439	-5466	-7905
All LDCs (incl OPEC)	84758	76026	-8732	-10	115288	98373	-16715	-15	-30530	-22347	8183
World	228870	207158	-21712	-9	259012	242340	-16672	-6	-30142	-35182	-5040

Notes: Exports are Census basis, domestic exports, fas value.
Imports are Census basis, imports for consumption, customs value.

U.S. Domestic Exports of Selected Product Groups to Six Countries in Latin America and the World, 1978-81 and 1981-82

Product Groups		Percentage Change 1981 - 1982		Average Annual Growth 1978 - 1981	
SITC Code	Product Description	Six Latin American Countries	World	Six Latin American Countries	World
79	Trans. Equip. except road motor vehicles	-50.25	-15.99	+39.82	+21.42
04	Cereals and cereal preperations	-43.71	-24.25	+29.22	+17.68
78	Road Moter Vehiles	-37.39	-14.72	+21.19	+5.35
74	Industrial Machinery and Equip. (nes)	-32.62	-14.52	+22.98	+15.33
71	Power Generating Mach. and Equip.	-23.21	+0.27	+24.17	+17.00
72	Machinery for Particular Industries	-21.59	-10.89	+24.00	+20.04
77	Electrical Machinery, Appliances & Parts	-17.93	-3.91	+22.51	+15.95

Notes. Data refer to aggregate for: Argentina, Brazil, Chile, Mexico, Peru and Venezuela. Average annual growth rates for 1978-81 are compound rates from natural log regressions of the form $\ln(x) = a+bt$, with 4 observations. Commodity groups are those totalling (for the six countries) more than $1 billion at the 2-digit SITC level of disaggregation.

Senator HEINZ. Mr. Olmer, thank you very much.

You have come out in strong support of an increase in the IMF resources for two reasons:

One, that we need it in order to stabilize the international monetary system upon which the world trading system depends and second, that we have a great personal stake in trade and exports, in the jobs that that creates.

You paint a very gloomy picture of the trade situation overall and how that is directly attributable to the debt situation. On page 10 of your statement, you estimate that 46 percent of the 2.6 percent drop in the U.S. GNP through the fourth quarter of 1982 can be explained by the deterioration of the U.S. external account.

Now how much of that drop overseas to the 46 percent do you attribute to the debt situation, as opposed to the global recession or to the high volume and the exchange rates that you mention?

IMPACT OF LDC DEBTS

Mr. OLMER. I think one of our problems, Mr. Chairman, is our difficulty with any precision coming up with a disaggregated determination in that respect. We have seen clearly, as I pointed out in part in my prepared statement, overall for six Latin American countries a drop of some 28 percent in our trade, worldwide a 9 percent drop. But I don't believe anyone has a precise, perhaps imprecise, calculation of what part of it resulted from LDC debt or from exchange rate fluctuations.

Senator HEINZ. Although I favor what the administration proposed, I don't want us to oversell it and raise unrealistic expectations.

You mentioned that Mexico—our trade with Mexico has dropped 36 percent. How much of that has to do with debt or recession or the high volume, or all three of those?

Mr. OLMER. Clearly, all three of those have had an effect, but in my judgment the largest single factor has been the massive debt problem.

Senator HEINZ. What about their local content law, their performance requirements?

Mr. OLMER. Their performance requirements are a direct outgrowth of what they perceive to be the domestic financial problems.

Senator HEINZ. In 1981, if my memory serves me correctly, we had $8 billion worth of exports to Mexico. That dropped to slightly over 4 billion in 1982.

How much of that drop was attributable to their performance requirements, their local content legislation if you will, irrespective of the reason for their enacting that local content legislation?

Mr. OLMER. I don't have an answer to that, Mr. Chairman. We could try to develop it, but I think it would be heavily caveated.

Senator HEINZ. With respect to Argentina, which you mentioned——

Mr. OLMER. If I might interrupt, sir, part of the reason is a number of U.S. companies, U.S. exporters, have managed to live with Mexican performance requirements and would assert that, while they prefer it didn't exist, they have managed to continue selling and buying in the Mexican market, and therefore, it is not an overburdensome element.

Senator HEINZ. With respect to Argentina, where you cite a 40 percent figure, how much of that is as a result of the political situation in Argentina and partly as a result of our having been on the winning, but from their point of view, wrong side?

Mr. OLMER. A great deal of the precipitous drop was directly related to the Falkland Islands situation last year.

Senator HEINZ. So what we are saying is it is really difficult to figure out exactly how much of the decline in our exports the world credit picture can be attributed just to the overextension of debt, but in your judgment it is a substantial but perhaps not—perhaps no larger than some other factors?

Mr. OLMER. I think it would be no smaller than most other factors. In some cases, with some countries, and with respect to certain product areas, it might even be by far the most significant element.

Senator HEINZ. In your conclusion to your analysis, I think you state quite effectively the kind of delicate choice we have between encouraging the necessary adjustments and the consequences of that and not encouraging the necessary adjustments and the Hobson's choice we have there with respect to what specifically is proposed by the administration, which adds up to $8.4 billion in terms of both the GAB and the IMF quota increase.

Do you feel that the conditionality that is on the books of the IMF that Mr. deLarosiere will implement as part of any assistance—do you feel that they will have in the short run an effect on depressing U.S. exports further?

Mr. OLMER. In my judgment, no question. One of the reasons that I believe it necessary to encourage closer working relations between GATT and IMF is to limit that as far as possible.

Senator HEINZ. If that is what is going to happen, why isn't it reasonable for us who are supplying both the financial assistance and who will take some penalties and effect in the short run in terms of trade to impose or require to be imposed by the IMF a lot more long-term—medium-term, if you will—requirements, that as part of conditionality there be basic reforms in the trade policies of countries that are going to be beneficiaries, reforms of GATT as a goal, more conformance with free market principles, as opposed to barriers in intervention?

Mr. OLMER. I think it is entirely reasonable. It is my understanding it will be done.

Senator HEINZ. What is there in the IMF regulations that in fact suggest this would be done? My understanding is there isn't much.

Mr. OLMER. Well, I think in the last couple of days you have been seeing some of the administration's effort in this regard surface publicly; that is to say, the increasing attention paid to the trade implications of this growing problem and ominous problem of LDC debt.

It would be an objective of the administration to assure adjustment policies which have minimal long-term effect on our commitment to the international trading system. In the short run, I think there are going to have to be some compromises made which acknowledge the necessity of doing things we don't like and that we realize would violate some of those commitments.

POWER OF PERSUASION OVER IMF POLICIES

Senator HEINZ. The United States is the only member of the IMF that really has a veto power over IMF policies.

Are you saying that we would be prepared to use our influence in order to make it clear what we expect over the long term or the end of the 3-year period over which these conditional agreements exist, as to what policies we would expect to see ultimately implemented?

Mr. OLMER. It is my understanding we will attempt to use our powers of persuasion to develop the right mix of adjustment policies, but that doesn't mean that I am suggesting the administration is preparing to use a veto. I don't believe that would be necessary. I certainly hope it wouldn't be necessary.

Senator HEINZ. I am not suggesting we use our veto. In fact, we never had to use our veto because we have the influence of it.

My question is not directed to whether you want to use the veto. My question is what are we going to use our influence to propose in the way of changed conditionality?

Mr. OLMER. Well, conditionality, as I understand it, has not always been—conditionality in the comprehensive sense that we are talking about—has not always been the only hallmark of IMF funding practices. I think we are bringing a more sophisticated understanding to bear on the nature of the problem, an understanding that just did not exist perhaps as recently—it didn't exist among many people interested in these matters as recently as a year ago.

I know that in the Commerce Department itself we had not paid a great deal of attention to such matters and we are designing our own program as we go along now to better assist exporters in the kinds of problem situations we know are going to occur within the next several years, and I think—at least I have confidence in the administration's ability to work the same disciplines into the new kind of conditionality that Secretary Regan announced yesterday.

Senator HEINZ. I think we are going to have to be a good deal more specific to satisfy the Members of Congress on this point, Mr. Secretary. There is clearly no great enthusiasm, as you may have gotten from Senator Proxmire about the idea of authorizing over $8 billion without a very clear idea of how the authorization of that in the longer run is going to be to the benefit of this country and a freer international trading system.

This country has been in the forefront ever since Bretton Woods of championing a freer international trading system. We look, however, particularly with respect to the developed countries, but some of the less developed ones as well, as a result of the Tokyo Round and the effect of the tariff concessions which we made, in return for which we got signatures on the Antidumping Code, on the Subsidies Code, and a variety of other measures with which you are intimately familiar, and certainly the administration enforcement of it.

You have done a very, very good job. But as you know, there is a good deal of disappointment that when we cut our tariffs, the kind of reciprocity that we achieved as a result was nontariff barriers springing up to frustrate our efforts at bringing about a freer world trading system. I must tell you candidly there is this concern, and in some cases suspicion, that having financed through the IMF the recovery of these LDC's, that they will become as a result more protectionistic, more interventionistic. They will do more in the way of subsidies, nontariff barriers, barter performance requirements and countertrade than they are doing today and will do a year from now as a result of conditionality.

If that is going to be the case, we would like to see that prevented.

I have to tell you, what you said is we have no plans to prevent it, we might get some plans, we might not. And in my judgment, that is not going to be good enough for the Congress.

Mr. **Olmer**. There are no guarantees, Mr. Chairman, at all. I would be the last to contend that there are.

Secretary Regan has announced a five-part strategy that the administration has undertaken. One part is the restoration of sustainable economic growth and the preservation of free trade.

I am not now dismantling or proposing to dismantle our antidumping, countervailing duty work force. In fact, I hope they will have sharpened pencils and renewed motivation after completing steel, because I anticipate an upsurge in the kinds of cases we have only seen the tip of the iceberg of.

Senator **Heinz**. You have got your hands full with the developed countries in those areas. What we are talking about are a lot of LDC's, the number of which is considerable, the variety of trade issues extremely numerous, and what we are saying is we don't want to participate in a lawyers' bonanza of litigating petitions under all of those statutes that you enforce, not because you don't enforce them well, but because it is expensive, it is time-consuming, it is painful, and during that process it is ultimately quite injurious to the industries that are involved.

What I would really urge you to do is find a way, if not today, at some future point, come forward with some proposals that the United States will seek—responsible proposals that the United States will seek to implement through the IMF in the way of long-term adjustment that will indeed follow through on implementing one of the Secretary's principles, which is a freer world trading system.

As I listened to the Secretary yesterday and to you today, there is no such evidence on the record that we have a means of implementing that principle.

I think you would agree with that, good intentions notwithstanding.

Mr. **Olmer**. What I further agree to is "like a free lunch, there ain't no such thing as free trade." It is a goal toward which we like to believe most nations work in the realization that you make incremental improvements. What we have seen since the—for example, the commitments policy on the elimination of subsidies that was undertaken in the Tokyo round, we have seen either a substitution of performance requirements, subsidies go underground, they are harder to find, or certain nations, including LDC's, reneging on those policies that had been made in return for concessions by the United States.

We now have over two dozen countervailing duty cases that exist just between Mexico and Brazil, and of course, there is some double counting when you are involved in antidumping investigations or cases that have been concluded, but we now have over two dozen nonparticipating members.

We work with them. We tell them we are not here to allocate markets and provide a sure entry on subsidized goods into the U.S. market system.

But frequently it is catching people after the fact and not being able to obtain from them up-front commitments which you can be assured of to any reasonable degree of certainty will be lived up to.

I don't think you can find that in the IMF conditionality agreement either.

Senator HEINZ. You are proposing—we are proposing $8.4 billion in authority. To what extent is that going to affect interest rates, the availability of credit in the United States? To what extent is it going to be crowding out?

Mr. OLMER. I don't think it is going to have a significant effect on that at all, sir.

Senator HEINZ. That is, $8.4 billion within a certain amount of time won't be available for U.S. business, industry, consumers, home buyers, auto buyers. How can $8.4 billion be insignificant?

We have been in Washington too long—a billion here, a billion there.

Mr. OLMER. To humble folk like myself it is very significant, but speaking only for myself, it is a large amount of money. In terms of capital availability, I don't think it is going to have a significant effect on interest rates.

As I pointed out in my testimony, we are making provisions to have available to U.S. exporters Eximbank guarantees and an assurance that personal banks continue their involvement.

BANK "BAILIN"

I think, as Secretary Regan phrased it yesterday, this isn't a bank bailout, but a bailin. The commitment in the IMF will be undertaken with the involvement of commercial banks, and I think that will assure the availability of private credit.

Senator HEINZ. Actually, it is the opposite, because, as was pointed out yesterday, for every dollar that we commit to the IMF, the ratio, as I recollect, was about— excuse me—for every dollar the IMF commits, it requires, in effect, about $4.3 to be committed by banks, not all of whom are ours but a large proportion of whom are ours.

It seems to me that if we are talking about $8 billion in U.S. funds we are talking $32 billion, maybe more, of bank funds. So it seems to me we would be bailing the banks in, which is what is happening here, and could have a very significant effect on the availability of credit in the United States.

Mr. **Olmer**. We will watch it very carefully, Mr. Chairman. My sense of this—I am reaching into the edges outside my competence—is that there is no alternative.

Senator **Heinz**. I would agree with that, but I think we just have to be honest with people, that this is not just an $8 billion program. It requires banks being bailed in, and in some way that is almost worse than bailing banks out, if it has an effect on the availability of credit.

Now hopefully, we are not going to have to call down all these funds that we make available to the IMF all at once. Hopefully, they will be spread out over several years. And of course, hopefully, the entire operation, which is to avoid international financial collapse, which would trigger all trade and plunge us into the kind of economic circumstances that we suffered in the 1930's, is the scenario we will avoid by virtue of this.

I think the moral of all this is we have a bad situation. We have two choices. We can live with some real inconvenience, at least in the short term, some additional inconvenience, but it is to avoid a far worse situation that may collapse.

Mr. **Olmer**. Mr. Chairman, I am not certain whether this arose during your hearings yesterday or is likely to in subsequent hearings which you will have, but many of the estimates that have been made in connection with the appropriate IMF packages are being conditioned on judgments regarding current oil prices. For example, a drop, and not necessarily a precipitous drop, in the price of oil will have a ripple effect on the calculations that will require another look.

I happen to think that it would be a good thing if oil prices dropped, a good thing for most nations in the world, but it will have a significant effect on trade again, as well as on economic activity generally—a positive effect on economic activity, a positive effect mostly on trade activity, but perhaps in the case of Mexico, a rather delicate and even more difficult situation.

Senator **Heinz**. Most experts agree that the global recession is a very important part of the debt picture, the trade picture. We are hoping for recovery this year. We hoped for one last year, but we didn't get one last year. We have certainly more hopeful signs this year.

We had a hearing yesterday morning on the housing industry, which is certainly showing, for now at least, signs of life.

But let me say there are some discouraging signs if you look at what is happening to 30-year Treasury bills, which tend to track 30-year mortgages. They are rising in terms of interest rates; they are declining in terms of price. That is not a good sign.

So, it is maybe not probable but certainly possible that global economic conditions might not improve. If that happened, the debt problems would become more serious. What steps can we take now to either prevent or prepare for that possibility?

Mr. **Olmer**. I think the best thing we can do is take the kinds of steps that will stand the best chance of continuing the likelihood of an economic recovery in this country, and from this country leading the rest of the world out of an economic recession.

I don't believe that there are in place any alternative strategies to deal with the eventuality of worsened or continuing stagnating economic conditions.

I think we are operating on the assumption of an economic recovery in this country and subsequently in the rest of the industrialized world, pulling us out of the dilemma that we're in.

In the absence of that, I think we are going to be in truly deep trouble.

U.S. INTERNATIONAL BANKS WERE IMPRUDENT

Senator Heinz. Do you believe U.S. international banks were imprudent in the way they extended this tremendous—their part in this tremendous amount of debt to LDC's?

Mr. Olmer. Well, sure, there was a measure of imprudence, yes.

Senator Heinz. Would you support legislation that would alter banks' country lending limits and the reserves required for loans as a means of regulating more prudently?

Mr. Olmer. The one thing that I think we should be concerned about and mindful of is the possible, as they say, "signal" that we send. It is essential that commercial bank lending continue, and if such legislation would have the effect of giving commercial private banks the jitters, causing them to stay away at a time when capital availability is even more important, I think I would not——

Senator Heinz. Presumably we're not going to be so short-sighted as to make the IMF operations impossible by doing something like that.

I'm really talking about trying to prevent the recurrence of the kind of situation we have in a prospective way.

Mr. Olmer. I think it's clearly worth looking at. I think it's clearly worth looking at the decisionmaking process to whatever extent is possible, to pinpoint the imprudence that may have existed.

Senator Heinz. Are you suggesting there was inadequate information available to banks?

Mr. Olmer. I think in some cases, there probably was inadequate information, partial information. I think a great deal of judgment being made about the profligacy of bankers is anecdotal, and it isn't based on any hard analysis of what conditions actually existed at the time.

Whether it was more pull than push——

Senator Heinz. What can the Commerce Department do, if anything, about getting better information, not just for business but for banks?

Mr. Olmer. On our part, we are beginning this week to work with the Treasury Department. Our desk officers in the Commerce Department who have, I think, a more refined appreciation of the trading patterns with respect to countries in their jurisdiction, will be working with the Treasury Department officials in their effort to review the IMF conditionality program; as well as hopefully a better understanding of how we can help the exporters in the face of currency fluctuations.

We in the last 6 months—in fact, we just completed a worldwide review of the disposition of our foreign commercial resources, and we have proposed to the State Department the reallocation of those resources, based on where we think the most likely markets are for U.S. exporters over the next couple of years.

We are, as you know, actively promoting the export trading company legislation. By the end of this month, there will have been roughly 10,000 paying attendees at seminars that we have run all across the United States.

People who paid between $50 and $100 for a 1-day seminar in the use of the ETC. And we're very pleased about that.

We have several bilateral trade commissions in effect, and I think that some of them, particularly the one with Mexico and Brazil, need to be invigorated.

Senator HEINZ. Let me represent, I think that what you are doing in that respect is commendable.

On the other hand, let me observe the Commerce Department is unique, except of course for the State Department, in having individuals in U.S. Embassies around the world.

The Treasury Department doesn't have those kinds of eyes and ears. The Federal Reserve System, Comptroller of the Currency, none of those agencies have those kinds of eyes and ears.

To what use can you put those commercial attachés who work directly for the Department of Commerce to help analyze these kinds of problems and prevent U.S. businesses, and in this case, banks, from getting involved in bad situations before it gets worse?

Mr. OLMER. In fact, the Treasury Department does have a financial attaché in the major posts in U.S. Embassies throughout the world.

Senator HEINZ. Isn't that principally the OECD's?

Mr. OLMER. Yes.

Senator HEINZ. Our problem here is the LDC's.

Mr. OLMER. Our problem is clearly the LDC's. The foreign commercial offices have been developing their ability to help U.S. exporters. That necessarily involves an analysis of the conditions extant in that country.

It seems to me there is a larger responsibility that will fall on shoulders in these circumstances. We have, as I say, in the course of reviewing where we ought to put the resources the limited resources that we have, recognizing it's far less than 200, about 135.

But in any event, they've got to do a better job, or they're not going to exist in some of the poorer LDC's. We're going to be taking them out of there because of the limitations we expect in export opportunities.

In the case of Mexico, we're actually increasing because of our judgment that that has been and will be a major export opportunity for American companies.

I anticipate that there will be a large demand on the commercial officers——

Senator HEINZ. It is not a great export opportunity if they don't get paid?

There's $35 billion Exim and related kinds of debt, U.S. Government guaranteed for finance commitments out there. It's not a good deal for the taxpayer, if we don't get that back.

Mr. OLMER. It's a good deal for the American businessmen who went into that export market to face the consequences of.

On the one hand, I thought you were suggesting we need to beef up our ability in those countries to advise U.S. exporters——

Senator **Heinz**. That's what I am doing, suggesting. I'm not sure we need to beef it up. I'm just questioning whether or not we were making use of the resources and the assets, the human assets, that we have.

And whether those people have a mandate, have a management directive, if you will, to give honest, timely appraisals of the financial conditions in those countries that will be used by both business and financial institutions so that they don't become overcommitted.

Mr. **Olmer**. The extent of our ability to understand the very dynamic situation taking place in Mexico has been somewhat limited.

And clearly the U.S. commercial officer who has traditionally served in an export promotion role, who may not have a competence in matters of high finance, may not be the best person to advise very sophisticated U.S. experts of high technology on whether or not there is a financial risk involved in that pending transaction.

But to the extent they have the ability to report on such circumstances, we will see to it that they continue to do so.

Senator **Heinz**. I will yield to Senator Lautenberg. But let me just observe, three countries—Argentina, Brazil, and Mexico—account for a lion's share of this.

LACK OF COMMERCIAL AND FINANCIAL INTELLIGENCE

It seems to me that for us not to really at least target our appropriate commercial and financial intelligence gathering, toward the three most obvious users of international credit, is certainly not malfeasance, but probably misfeasance on our part.

I can't, however, criticize the Commerce Department. They have not had that responsibility. I can't criticize the specific agency.

But it seems to me when you have three such heavy users and you don't know what the heavy users are doing, you have violated the basic principles of management, which is to focus on the most important parts of your market, which will become the most important parts of your problem.

Mr. **Olmer**. Let me give you an example of where we have as a government done, I think, an effective job. That's in Mexico.

We have met in this United States-Mexican Joint Commission on Commerce and Trade and established various working groups to deal with industrial sectors.

We have met with representatives of U.S. business through the United States and American Chamber of Commerce, United States-Mexican Chamber of Commerce, in Mexico City and in the United States, to better understand the particular problems which exporters are facing, and potential exporters are facing.

We broadcast that information through a variety of means. Commerce Department publications, seminars that we hold in the United States, including one that was held 2 weeks ago in Los Angeles on Latin American trade opportunities in general.

The ability that we have, however, to predict what's going to happen in a country such as Mexico is rather limited.

As I think you may know, Senator, the Mexican devaluation was a major secret that I think even senior Mexican Government officials were embarrassed to admit the day after, they weren't aware it was about to take place.

Senator Heinz. Only the most secret—only the highest Mexican officials, most of whom are no longer with the Government, made the necessary preparations. [Laughter.]

Mr. Olmer. That may be. I'd also like to point out that while our exports to Mexico have dropped in 1982, they were still over $11 billion.

It does seem to me that there is a very, very substantial interest on the part of American businessmen who are taking advantage of that $11 billion, that it continue and that the efforts of the Commerce Department in promoting that continuation not be diffused by trying to make an export promoter into a financial analyst.

Senator Heinz. I understand that. I think what you say simply illustrates the need for perhaps a new solution. There are only nine countries that are really heavy debt users here.

After hearing your testimony and answers to the questions, I concur that you shouldn't try to make an export expert into an international debt expert.

But I am convinced that we better find somebody who can be.

Senator Lautenberg.

Senator Lautenberg. Very briefly, I'm sorry, Mr. Olmer, that I didn't have a chance to hear your presentation. But I will read it. I scanned it very quickly here.

The question that arises in the debate most often is the one concerning the additional resource, that it is going to take to support our commitment to IMF, and there are many advocates who say we will create more jobs by investing the money back in our societies.

Others say it will create exports and other things, job opportunity, or business opportunities on the international side.

In connection with that, and regarding your statement here, it says, "High-debt LDCs will need to reduce their imports and expand their exports further if they are to meet their debt service."

I'm sure that after I read it in more detail, I will see how that connects with the contention that our job opportunities will be improved or our business opportunities will be improved.

We're going to have to buy more, obviously, or whoever is a customer for these countries will have to be buying more as we export less.

Mr. Olmer. Senator, you put your finger on the dilemma. It is necessarily going to be a very delicate balancing act between the austerity program, which the debtor nation has to undertake in order to get its financial house in order, and the legitimate interests of the United States and the OECD countries, to maintain to the maximum extent a free market system.

We think there's no question that in the long run, it is in the interest of U.S. businessmen to see this program through its course.

In the absence of this, we think that there would be a rather rapid deterioration in the volume of trade and in trade opportunities of the U.S. exporters, period.

That was the rising tide of protectionism that would simply get out of control.

But the specific answer to your question, if I understood it correctly, will there be lost jobs that result from some of these austerity measures; then the answer is yes.

Senator **Lautenberg**. Thank you for your candor. Again that leaves me with a choice, and I think about it very seriously, because I do understand that we have an obligation as the world's leading power to do as much as we can for a stable international financial structure.

On the other hand, there's a competition for resources. Thus I also know it's tough to make a decision.

Mr. **Olmer**. Thank you, sir. We have an enormous stake in the world trading system.

That stake is by no means assured by the program that Secretary Regan announced yesterday, but I believe in all honesty it's the best hope that we have.

Senator **Lautenberg**. I couldn't help, Mr. Chairman, but agree when you pointed out what might be construed as delinquent or deficient in terms of specific trading partners, or borrowers from IMF.

One of the problems that I had with another department was trying to get a definition of delinquent. Certainly not default, because that's not permitted. That's avoided by an adjustment program.

It's a nice technology, but I am concerned about this area, that if despite our best efforts, someone does go into default, we will have a terrible problem, which may cause statements from people here such as: "What's happened; why do we continue to throw more money into this situation?"

Senator **Heinz**. Thank you, Senator Lautenberg.

Thank you, Secretary Olmer. Thank you for coming by. You've done an excellent job.

Senator **Heinz**. Our next witnesses are a panel consisting of Mr. George Champion and Mr. Martin P. Mayer.

STATEMENT OF GEORGE CHAMPION, FORMER CHIEF EXECUTIVE OFFICER, CHASE MANHATTAN BANK

Senator **Heinz**. Mr. Champion and Mr. Mayer, welcome.

Mr. Champion, would you please proceed?

Mr. **Champion**. Mr. Chairman, Senator Lautenberg, I apologize, but this dictation of mine was done yesterday, and unfortunately I'm not in the position that I usually have such excellent help to make sure that there were no mistakes.

There were some. They have been edited last night by yours truly, but this is the poverty of inconvenience that I have to go through with as an old, retired man.

[The complete statement follows:]

Testimony of George Champion, Retired Chairman, the Chase Manhattan Bank

The explosion of credit to the developing and Iron Curtain countries is just cause for concern worldwide. The debt of the non-OPEC developing countries is reported to be over five hundred billion dollars, with no tangible evidence that their living standards have improved. Clearly this in itself indicates that there is something radically wrong with the policies of the past. At this time when the industrial nations are being asked to materially increase their commitments to the International Monetary Fund and loans to the developing countries, we must appraise the effects of the past program and make the necessary adjustments.

In 1944, the Bretton Woods agreement clearly allocated to the World Bank the only authority to make project loans and the International Monetary Fund was limited to advances to help countries over difficult periods when the balance of trade had gone against them. Virtually from the start, the developing countries wanted, above all else, capital intensive industries which were in a way a status symbol even though there was little or no chance that these components could compete in the world marketplace. From the start, there were only four countries, namely, Taiwan, Korea, Hong Kong and Singapore who apparently recognized they had a vast number of unemployed, untrained workers who could add materially to their economic wellbeing through the development of labor intensive manufacturing projects. In addition, these countries recognized the importance of private enterprise and maintained a low tax base. A healthy economic climate was created. The result was that private sector jobs multiplied and prosperity resulted with a vast improvement in living standards. Interestingly enough the real explosion of growth in Taiwan and Korea did not occur until foreign aid was discontinued. Obviously, this was not the pattern followed by most of the other countries.

Banks and the International Monetary Fund loaned them money at an unprecedented rate over the last ten years. The unfortunate part is that the recipient governments used some of the funds for their own expansion. Government is a consumer of wealth not a producer of wealth. If our experience in the United States is a pattern, it should be clear to all that government is a very inefficient, ineffective manager whether it be their own departmental operations or a business. We have not taken departmental operations out of politics. It is reasonable to assume that governmental management is even more ineffective and costly in the developing countries. Some of the loaned funds, directly or indirectly, were used to purchase military equipment. Other funds were invested in capital intensive industries. The result has been the creation of a heavy debt with little or no improvement in the living stardards.

When colonialism was terminated, the American people were never apprised of the limited education and training given the citizens of most of the countries. Indeed, in some countries, the natives were given absolutely no managerial responsibility. At that time, Chase had a continuous stream of bankers for protracted periods just to train them in basic operational procedures. Then we established three months' classes for Vice Presidents of various banks in order to show them the importance to the United States of helping the little businessman grow. This included basic reporting systems and the fundamentals of getting security such as a lean on inventories and receivables. These were articulate, able people but when they returned to their banks we saw little evidence of a major change in policy for the banks were being pressured to assist larger enterprises with the limited funds available. These programs clearly showed, however, that the greatest assistance that we could give these countries would be through education and training which must include the fundamental importance of our free enterprise system.

The Opportunities Industrialization Center, under the able leadership of Leon Sullivan, has had for several years training programs in Africa that have proven extremely successful. In some cases, starting with primitive villages, the people were taught the principles of sanitation, well-digging and the fundamentals of building a house from the products available locally. In addition, they were trained in the growing and storage of corn and other grains. As a result, in some of these communities a new spirit developed, living standards improved and even schools have been started. It will take generations to bring these people up to the standard of living we feel necessary but it can be and is being done. These programs could be greatly accelerated if the industrial nations agreed to emphasize self-help and jointly provided the leadership needed for training. Giving or lending money alone is not the answer to their problem for that fails to recognize the strength of a nation is a multiple of the character, energy and ability of its people, not its natural resources.

In my opinion, we have reached a point where we must call a halt to the programs of the past, not only because of their failure to improve the living standards of the developing countries but a continuance could jeopardize the financial soundness of the free world. Financial statesmanship will be required on the part of all participants, in order to solve the problem which I am sure can be solved over a period of time. If we are to succeed, I feel the following steps should be taken:

(1) The Treasury has recommended that the United States join in contributing to the requested increase to the Monetary Fund. In order that history not repeat itself and to be assured that there will be a limitation on the pouring out of aid injudiciously, I would strongly recommend that the increased advances be set aside in a special fund dedicated to assisting only those developing countries who are willing to readjust their financial affairs in such a manner that a repayment of these advances could be made in the reasonable future. As a further stipulation, I would suggest that the funds as they are repayed to the International Monetary Fund be used to repay the advances made by the industrial countries.

(2) The success of this program would depend upon the present creditors agreeing to defer all payments for at least three years and recognize that IMF advances are not to be used to pay interest or principle on present indebtedness.

(3) The banks would not be asked to make any additional commitments. In my opinion, commercial banks should not lend any foreign government.

(4) I would suggest that the IMF obtain every assurance that there will be free trade, that, particularly in those countries where government expenditures have expanded, there would be a very material reduction. With rare exceptions, an increase in taxes would further hamper free enterprise and should be discouraged. For those countries that are not willing to enter such a program, IMF should withhold loans and aid.

If we are to ask the developing countries to adhere to sound fiscal and monetary policies which could cause temporary hardships for many, we should by all means set the example by getting our own house in order. Over the last twenty years, there has been an unprecedented acceleration of indebtedness in the United States, personal, corporate, municipal, State and Federal, to say nothing of the indebtedness of the foreigners. Indeed, it could be said that we have been in a debit prosperity. High taxation, in my opinion, together with the lack of fiscal discipline are the main causes. With double digit inflation and interest paid tax deductible, the temptation to borrow individually, even though rates of interest were high, laid the basis for a vast program of individual credit expansion. In the corporate world, conglomerates multiplied as debt was substituted for equity in most of the purchases. This couldn't have been justified except for the fact that fifty percent of the interest paid on the indebtedness was tax deductible.

High taxes have a negative effect on the competitive position of American enterprise in the world markets. This, coupled with our heavy domestic indebtedness, has materially slowed the readjustment in our economy. Unfortunately, many Americans do not realize that corporate taxes are, in the final analysis, a form of sales tax. It has been quite popular to say let the corporations pay which, of course, they can't do unless they add it to the price of goods or services delivered. In addition, the underground economy and the temptation for tax evasion proves that high taxation has been a very real factor in the drop in morals and so the character of our citizens. In order to assuage the impact of inflation and taxes, government has agreed in many cases to automatic salary, pension and tax adjustments to relieve the impact with the result it has discouraged self-discipline and lessened individual interest in good government. A flat tax rate with few if any exemptions would go a long way toward restoring a healthy domestic climate and indeed improving our self-discipline. Shortly after World War II, Albino SyCip, Chairman of the China Banking Corporation in the Philippines, came to this country by way of Europe and said "good money, healthy people. In my country the money is not good we have tax evasion, smuggling, underground economy. The morals of my people can't withstand these pressures and they are not working. In Germany and Switzerland they have sound money; as a result the people are working and the morals are high." There is a great deal to his basic philosophy and we should make every effort to see that the dollar is as good as gold.

After his election but before inauguration, I asked General Eisenhower who he was going to appoint as Secretary of Defense. He said, "the best production man in America. Production won both World Wars. We can't have a strong military if it isn't supported by a strong economy." America will increase in strength if we return to the fundamental philosophy for government and business based on Judeo-Christian ethics upon which this country was founded.

Senator **Heinz**. Mr. Chairman, thank you very much. Mr. Mayer?

STATEMENT OF MARTIN P. MAYER, NEW YORK, N.Y.

Mr. Mayer. I have a statement which is, I believe, before you. I would like to summarize the early part of it and read a little from the later part.

COUNTRY LENDING LIMIT FOR BANKS

On the matters which the staff has informed me you have been considering, I would like to support the idea of a country lending limit for banks, presumably tied, like the domestic lending limit, to a percentage of the bank's capital. Obviously to be phased in over time.

Recognizing that there are three different kinds of loans, one being a loan denominated in the currency of the borrower, made by branches or agencies of an American bank abroad. Such loans should be controlled by local, not U.S. laws.

The second category is the dollar loan to subsidiaries of multinational corporations that have access to dollars from various sources especially, but not exclusively, those with whose operations are in the United States.

To the extent that enforceable guarantees of payment can be secured from the parent, and that means the loan must be written under our laws, not under the laws of an LDC, I should think that also should be exempted from any country loan.

But all loans to governments, governmental entities, state-owned telephone companies, airlines, et cetera; private concerns in a foreign country, made in dollars to be repaid in dollars, I think should be aggregated under country lending limit, at some point looking down the road.

One of our more eminent international bankers, holding one of those more-than-vice-president posts at Citibank, used to brag that he had no worry about his bank's portfolio in Mexico, because there were 7,000 different borrowers.

He was soundly diversified. When push came to shove, it turned out all these borrowers were dependent on a single source of dollars to meet their interest payments and discharge their loans.

There is no means and purposes test that can be applied to discriminate in situations where everybody has a single source of dollars for repayment.

A second matter the staff tells me you have been considering is the question of accounting for fees paid by sovereign borrowers on the restructuring of their loan.

Some banks, by no means at all, by the way, take these fees directly down to earnings in the quarter they are received, if that is the right word for the immediate return of some money the bank has just lent.

Other banks amortize the fee over the life of the loan. The latter is the only acceptable procedure. It is hard to know whether legislation is needed here.

In another 2 months or so, the American Institute of Certified Public Accountants will publish a new guideline for audits of banks, which insists that:

A bank's method of accounting should insure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan.

If it is not practicable to separate a fee into component parts, the amount of the fee should be deferred and amortized over the combined commitment and expected loan period.

I have appended to my testimony the proof page from the book which the AICPA will be publishing in March or April.

Legislation may be desirable to keep banks and their accountants from inventing ways around this rule, but I would rather see the accountants take care of it themselves, having been put on notice that the Congress is watching.

What is most important to me, looking into the future, is that we shall not continue, domestically or internationally, to validate unwise and excessive extensions of credit to borrowers with uncertain prospects for servicing their debts.

Professor Hyman Minsky of the University of Washington at St. Louis has laid out the dangers repeatedly under the rubric of the financial instability hypothesis.

What is needed now is to let some air out of the balloon slowly, so it doesn't fly away from us. Not to blow it up again until we have stretched the skin to the point of explosion.

The way to deflate the balloon gradually is an end to the pretense that these endangered loans are sources of profit to the bank.

TROUBLE DEBT RESTRUCTURINGS

By any common-sense definition, these renegotiations are troubled debt restructurings. As such, they are covered by Financial Accounting Standards Board Standard No. 15, which requires that interest received be used to reduce the principal of the loan, rather than taken into income.

Because few of these loans will result in a total loss, and the sums involved are admittedly dangerously large, a reasonable distribution of the interest payments between loan loss reserve and income might be worked out between the banks and the regulators.

Nevertheless, it should be stressed, as Mr. Champion stressed in the Wall Street Journal, that the first line of defense against bad loans by any bank is the bank's profits.

Loan loss reserve is a second line of defense, and banks should be encouraged by the tax laws, not discouraged, as they are in 1983, to beef up that second line.

This will require legislation from you.

Capital is a last resort, and probably need not be touched in the workout of the current crisis. Even if capital did have to be invaded, the result need not be a shrinkage of domestic loans, as Treasury Secretary Regan has suggested.

The banks that are moaning most piteously today are the same banks that were insisting during the incumbency of Arthur Burns at the Fed that really the modern bank doesn't need any capital at all, because its liquidity is assured by its access to the markets.

None of this is to say—let me add one more thing on this.

The notion that borrowers who have once caused the bank a loss will lose their access to credit for years and years and years is contradicted off the top by the real estate and shipping portfolios now in the banks despite the awful experience of 1973–75, not to mention all the stories from the oil patch about the roustabouts who are going bust for the third or fourth time.

Sovereign defaults are unthinkable for the borrowers, not because they have to worry about their future, but because the immediate loss of short-term credits would devastate the trade on which they all depend.

But it is dangerous to keep increasing the burden service they must carry until nations are left with a choice between cutting themselves up to satisfy what will look like the ravenous wolves of international finance, or sallying forth to die like a man.

None of this is to say, of course, that the IMF doesn't need additional resources. It does. But the long-term purpose of Government intervention in the present crisis should be a transfer of borrowings from banks that simply cannot run these risks, which is after all, what they are saying, to governments which can.

If the risk is to be diminished, so in all logic, must be the reward. Quite apart from the Distaste all of us feel at the thought that the residents of the Brazilian favellas and the impoverished Mexican villages must grow even thinner so that the bank's bottom lines may stay fat.

Incidentally, the notions that loans should not go up that much is not entirely mine. In the famous speech in Boston in which Mr. Volcker said that new credit should not be subjected to supervisory criticism, he said in the paragraph before, and I quote:

> Given strong and necessary adjustment programs, borrowing countries will not require bank financing in amounts nearly as large as the sums provided by banks over recent years.
>
> "Indeed, lending banks working effectively together to meet a clearly justified transitional need, should be able to provide the necessary margin of finance while reducing ratios of outstanding loans, relative to their capital assets.
>
> In a number of instances, outstanding loans need not rise much, if at all next year, though negotiations to extend or roll over current maturities may be necessary.

We are losing the sense that we're in a problem here and that we mustn't come back to it again. I hear increasing numbers of people say "We have just got to get back to what we were doing, and everything's going to be all right."

I would like to deal, however, with some aspects of the situation that are not so frequently discussed, for which legislative remedies may be useful.

ABUSE OF THE FED FUNDS MARKET

What made the December crisis so near to unmanageable was the abuse of the Fed Funds market by the agencies and branches of foreign banks.

Fed Funds are usually defined as bank reserves kept at the Fed, and so they are. But they are also the transaction balances of a banking system that moves money back and forth on the wire-transfer facilities of the Fed.

The sums involved are unbelievable, literally hundreds of billions of dollars every day, the peak so far being $445 billion on a single day last September.

This incredible volume of flow is made possible by the extension of free daylight overdraft facilities by the Federal Reserve.

Around the noon hour, such overdrafts may be as large as the entire reserves of the banking system.

By the close of day, the banks must have regained their positive net positions with the Fed, and there is a great deal of trading of money back and forth on an overnight basis, to smooth out the jagged nature of payments made and payments received at unexpected intervals.

Much of this trading is done through brokers on a more or less anonymous basis. Banks that have an excess of payments to them this day sell Fed funds overnight to banks that have an excess of payments from them.

Branches of foreign banks have access to Fedwire, though the Fed does not permit them to run daylight overdrafts, and they participate in the Fed funds market.

In 1981, and to an increasing degree in 1982, branches of Mexican and Brazilian banks and some others used their access to this market to fund their nations' continuing and growing foreign exchange deficits.

It's hard to get a handle on the numbers, but something more than $10 billion may have been involved.

I asked a senior person at the Federal Reserve Bank of New York whether he hadn't noticed this rapid and very large growth of "takings" from the Fed funds market by the foreign branches.

"We noticed it," he said. Then he said, "I think it's fair to say we didn't think through what it meant."

I asked the treasurer of one of our half-dozen largest banks why he had continued to sell increasing quantities of Fed funds to such purchasers.

He said, "Well, they were paying an extra eighth." For an extra eighth, the leading banks of this Nation put in additional jeopardy the financial system of the world.

For once the news was out, any responsible regional banker selling Fed funds would be obliged, I think legally obliged, he could have been sued if he did anything else, to remove the names of these foreign branches from the list of banks to which he permitted his broker or traders to offer his Fed funds.

We have now seen for some months a disgraceful spectacle of the big New York banks, and indeed, the Federal Reserve, leaning on our regional banks to continue the dangerous practice of selling Fed funds to foreign purchasers who are using them for purposes quite illicit by the generally accepted terms and conditions of this market.

The Governor of the Brazilian central bank has just taken it upon himself in New York to threaten that banks that refuse to resume their sales of Fed funds to his wards will forever be barred from doing business in Brazil, a fate they may not consider as dire as he does.

The fact is that this market was fundamentally in the custody of the large-money center banks. The Fed did not supervise it; everyone believed that because they depended on it so largely—the New York banks as a group may take as much as $15 billion a night from this market they would protect it.

That confidence turned out to be misplaced.

To tell the regional banks that participated in the syndicated loans to Mexico, Brazil, Argentina, et al., that they must now stay the course, in for a penny, in for a pound, strikes me as perfectly reasonable.

They wanted to be part of the exciting world of international lending, and they have no right to back away when the game gets rough.

But the banks who simply permitted foreign branches as well as domestic peers to buy their Fed funds should be permitted to go home.

They relied upon the money center banks to be keeping this market in good order, and they were entitled to do so. So far as I can find out, they didn't get the extra eighth, only the big boys got that.

Now let the big boys cover. They made the mess, and they should clean it up.

Certainly the Federal Reserve banks and the Treasury Department should not prostitute themselves to the interests of the money center banks to keep the lesser fry in this dangerous game.

For the future, Congress should pass legislation restricting purchases and sales in the Fed funds market to banks using this money for domestic purposes.

Such legislation will be tricky to write, because there is an incessant arbitrage between the Fed funds market and the London interbank market, but after all, the Bank of England in this instance has every reason to wish to be helpful.

A very eminent person whom I do not feel at liberty to quote said recently that he thought what we needed was a way to restrict this market to banks that had a source of dollars other than a foreign central bank.

I leave the specifics to the technicians and the draftsmen.

Another matter, if I may, that should be thought on with the guidance of Congress, is the excessive use of the dollar internationally as the denominator of several key commodities, especially oil and credit.

In this country, we believe that oil prices have been stagnant or declining for the past 2 years. But if we were French, Japanese, or German, we would have no such belief. For the price of oil is up 40-plus percent in French francs, more than 20 percent in German marks and Japanese yen over the past 30 months.

Oil is sold only for dollars, and the dollar has risen that far in exchange value with reference to these other currencies.

APPRECIATION OF DOLLAR CREATES DEBT DEFLATION

For the borrowers of dollars whose export earnings are substantially denominated in other currencies, the appreciation of the dollar over the last 30 months has created a debt deflation. If their debts were in yen or marks or francs or pounds or special drawing rights, they would be much better off.

And while commodity prices have been depressed by the strong dollar, because a steady bid in other currencies has met a lower bid in dollars, the interest on dollar loans has been atrociously high because of our domestic need to control inflation and the lack of other means for doing so.

The only hope to get well that today's troubled borrowers have is a severe and soon deterioration of the dollar.

Given the merchandise trade deficit we will run this year, and the total lack of belief either domestically or internationally that either the Congress or the President will get a handle on the budget, that hope may become a reality.

When the banks tell you their economists have figures indicating that the borrowers can pull out all right, what they mean is that they expect the dollar to take a nose dive, and inflation to resume at a brisk, probably double-digit pace in this country before the lenders wise up and the interest rates soar again.

I expect we can all agree that this is a hell of a way to run a railroad.

We have structured for ourselves a world in which all instabilities are exaggerated by the fluctuating exchange value of the dollar.

Perhaps this is what Donald Regan sensed when he spoke wistfully of seeing whether that hotel is still on the mountainside at Bretton Woods.

If there were more use of other currencies or special drawing rights in international borrowing, and if the key commodities were sold for units of a basket of currencies, rather than for dollars, other people's problems and by extension our own, would be less terrifying to them. And by extension, to us.

If we come to adopt Professor Kenen's or Mr. Rohatyn's plans for stretching out the debts of the troubled borrowers, and I would certainly be on that side of the debate myself, I would hope we do so with multicurrency loans rather than just dollars.

Much of our obligation to help in this crisis derives from the fact that the Federal Reserve followed policies that may have been domestically necessary—I find no fault with Mr. Volcker—without attention to the side effects of a strongly appreciating dollar, and thus an increasingly heavy burden of dollar-denominated debt on the rest of the world.

As we look around for ways to assure that we do not again find ourselves where we are today, we must sieze the opportunity to take dollar off center stage occasionally and let it sing in the ensemble.

One such opportunity is upon us this year, when we will be borrowing very heavily in the international markets to finance a large current account deficit.

It is, of course, very attractive to borrow in a currency we can print. The Brazilians would have no trouble at all if people would take cruzeiros in repayment of Brazil's debts.

But there are long-range costs, of which the present crisis is only one example, in arranging the world so that our domestic policies so deeply influence what other nations can do.

From early on, and not as part of some emergency package to bail us out, like the one that was required in 1979, we should be financing some of this year's deficit in our international accounts by issuing Treasury paper denominated in currencies other than the dollar, perhaps in SDR's.

Because interest rates are lower in Germany and Japan than here, the costs of borrowing in an appreciating currency would not be as great as they might seem.

And by borrowing in foreign currencies from the start, we buy some insurance against a precipitous slide of the dollar such as we experienced in the late 1970's, as destabilizing in its way as the precipitous appreciation of the last 30 months.

It might be helpful if members of this body could indicate to the Treasury that in the next resolution enlarging the permissible size of the national debt, they will urge some part of the increase be denominated in foreign currencies.

PROMOTE DEVELOPMENT OF POOR NATIONS

A final point. If it is American public policy to promote the development of poor nations, and I take it that this has been an American policy since Harry Truman and Point 4, then the American taxpayer must be prepared to pick up a good piece of the tab.

Many of today's troubles arise from the Government abdication of what were really Government responsibilities during the 1970's.

Quite apart from all the true stories, anecdotes of extravagance, corruption, and folly on the merry-go-round, the motive power was supplied largely by Government's efforts to duck this problem.

To the extent that the rescue must now be mounted with Government carrying a larger share of the load, everyone should keep the purposes in mind. First, to reduce the debt burden on the countries that can't bear them.

Second, to prevent a generally damaging shrinkage in international trade.

Third, to assure that the banks will not be so "unlucky" as to do this to themselves, to the developing countries, and to the rest of us, all over again. Next time with even bigger numbers and perhaps more disastrous results.

The first objective requires a reduction in the interest rates these borrowers must pay, not unlike the reduction a well-run bank gives a troubled domestic debtor to tide him over his troubles.

The second requires that new money be made available to the debtor countries—and that the new money made available to the debtor countries be spent for purposes other than making interest payments to the bank.

The third requires that banks not be permitted to pretend that unsound lending practice is profitable.

I note without specific suggestions for legislation that all three purposes would be served by a rule to restrict the interest rates banks can charge when participating with Governmental or inter-Governmental agencies in the restructuring of sovereign debt.

Thank you.

[The complete statement follows:]

Statement of Martin Mayer

My name is Martin Mayer, and I am a writer with training in economics. I have been writing about financial matters with varying degrees of persistence and intensity since the 1950's. I am the author of books called "The Bankers" and "The Fate of the Dollar," and of numerous magazine articles on financial and business subjects, and I am in the process of completing a book with the working title, "The

Future of Banking." I have written a book about diplomacy, which will be published in the fall under the title "The Diplomats." While working in education, I served in the Kennedy and Johnson administrations as a member of the President's Panel on Educational Research and Development, and I served the incumbent administration from July 1981 to April 1982 as a member of the President's Commission on Housing.

My hope here is to call the committee's attention to some aspects of the debt crisis that have not been widely discussed, but I should like first to comment on proposals the staff tells me are already under consideration.

The first is a country lending limit for banks, presumably tied, like the domestic lending limit, to a percentage of the bank's capital. There are, I think, three different kinds of loans to be considered. One is loans denominated in the currency of the borrower, made by branches or agencies of a American bank domiciled abroad. Such loans should be controlled by local, not U.S., laws. A second is dollar loans to subsidiaries of multinational corporations that have access to dollars from various sources, especially but not exclusively from their operations in the United States. To the extent that enforceable guarantees of payment can be secured from the parent, loans to such enterprises should not be categorized as country loans. The third is the loan to a government, a governmental entity (state-owned telephone company, airline, etc.) or private concern in the foreign country, made in dollars to be repaid in dollars.

For this third category, I think a legal lending limit is essential, and everything in the country should be aggregated against the limit regardless of any "means and purposes" test. Fifteen percent of capital is enough for a bank to have outstanding in a single foreign country. One of our most eminent international bankers, holding one of those more-than-just vice-president posts at Citibank, used to brag that he had no worry about his bank's portfolio in Mexico because there were 7,000 different borrowers: he was soundly diversified. When push came to shove, it turned out that all these borrowers were dependent on a single source of dollars to meet their interest payments and discharge their loans. Lines of dollar credit to U.S. branches and agencies of foreign banks should also be aggregated for control within these limits except to the extent that these branches are using the money to acquire dollar-denominated assets inside the United States, or the lines are matched with—and can be offset against—credits in the foreign currency extended to foreign branches of U.S. banks by the parents of the branches seeking the dollars credits.

A second matter I gather has been receiving your attention is accounting for fees paid by sovereign borrowers on the restructuring of their loans. Some banks take these fees directly down to earnings in the quarter they are "received"—if that is the right word for the immediate return of some money the bank has just lent the borrower. Other banks amortize the fee over the life of the loan. The latter is the only acceptable procedure. It is hard to know whether legislation is needed here. In another two months or so, the American Institute of Certified Public Accountants will publish a new guideline for "Audits of Banks," which insists that "a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan . . . If it is not practicable to separate a fee into component parts . . . the amount of the fee should be deferred and amortized over the combined commitment and expected loan period." (I have appended the proof page to this testimony.) Legislation may be desirable to keep banks and their accountants from inventing ways around this rule, but I would rather see the accountants take care of it, having been put on notice that the Congress is watching.

The U.S. Government has at various times regulated loans to foreigners by American banks. In the Harding administration, there was an interesting dispute between Charles Evans Hughes as Secretary of State and Herbert Hoover as Secretary of Commerce as to which Department should be responsible for such regulation. The criteria employed in this regulation were very broad—at one point in the Prohibition era, for example, the State Department denied permission for a loan to a Czech brewery on the grounds that U.S. banks should not make loans for purposes that would be illegal in the United States. (It was Pilsener Urquell, by the way; the old-time bankers had good taste.) My own estimate of the situation is that the government would make even worse decisions than the banks have made, and it should be remembered that some of the most impossible loans now on the books of our banks—those made in summer 1980 to Poland, for example—were urged upon them by the government. Politicizing the process of foreign lending is not likely to contribute over time to the safety or soundness of our banks—or to the stability of our relations with other countries.

What is most important looking into the future is that we shall not continue, domestically or internationally, to validate unwise and excessive extensions of credit to borrowers with uncertain prospects for servicing their debts. Professor Hyman Minsky of the University of Washington at St. Louis has laid out the dangers repeatedly under the rubric of the Financial Instability Hypothesis. What is needed now is to let some air out of the balloon—slowly, so it doesn't fly away from us—not to blow it up again until we have stretched the skin to the point of explosion.

The way to deflate the balloon gradually is an end to the pretense that these endangered loana are sources of profit to the banks. By any commonsense definition, these renegotiations are Troubled Debt Restructurings. As such they are covered by Financial Accounting Standards Board Standard No. 15, which requires that interest received be used to reduce the principal of the loan, rather than taken into income. Because few of these loans will result in a total loss, and the sums involved are admittedly dangerously large, a reasonable distribution of the interest payments between loan loss reserve and income might be worked out.

Nevertheless, it should be stressed that the first line of defense against bad loans by a bank is the bank's profits. Loan loss reserve is a second line—and banks should be encouraged by the tax laws, not discouraged as they are in 1983, to beef up that second line; this will require legislation from you. Capital is a last resort, and probably need not be touched in the work-out of the current crisis. Even if capital did have to be invaded, the result need not be a shrinkage of domestic loans, as Treasury Secretary Regan has suggested. The banks that are moaning most piteously today are the same banks that were insisting during the incumbency of Arthur Burns at the Fed that really the modern bank doesn't need any capital at all because its liquidity is assured by its access to the markets.

What many of the banks have been saying boils down to a peevish threat that if they are made to pay for their mistakes, even the least little payment, they will commit suicide and then we'll all be sorry. You wouldn't accept that argument from your children, and you shouldn't accept it from the Chase Manhattan Bank. The notion that borrowers who have once caused the bank a loss will lose their access to credit for years and years and years is contradicted off the top by the real estate and shipping portfolios now in the banks despite the awful experience of 1973-75, not to mention all those stories from the oil patch about the roustabouts who are going bust for the third or fourth time. Sovereign defaults are unthinkable for the borrowers not because they have to worry about their future but because the immediate loss of short-term credits would devastate the trade on which they all depend. But it is dangerous to keep increasing the burden of debt service they must carry, until nations are left with a choice between cutting themselves up to satisfy what will look like the ravenous wolves of international finance, or sallying forth to die like a man.

None of this is to say, of course, that the IMF doesn't need additional resources: it does. But the long-term purpose of government intervention in the present crisis should be a transfer of borrowings from banks that simply cannot run these risks (which is, after all, what they are saying) to governments, which can. If the risk is to be diminished, so in all logic must be the reward—quite apart from the distaste all of us feel at the thought that the residents of the Brazilian favellas and the impoverished Mexican villages must grow even thinner, so that the banks' bottom lines may stay fat.

I should now like to deal with some aspects of the situation that are not so frequently discussed, for which legislative remendies may be useful.

What made the December crisis so near to unmanageable was the abuse of the Fed Funds market by the agencies and branches of foreign banks. Fed Funds are usually defined as bank reserves klept at the Fed, and so they are, but they are also the transaction balances of a banking system that moves money back and forth on the wire-transfer facilities of the Fed. The sums involved are unbelievable—literally hundreds of billions of dollars every day, the peak so far being $445 billion on one day last September. This incredible volume of flow, incidentally, is made possible by the extension of free daylight-overdraft facilities by the Federal Reserve. Around the noon hour, such overdrafts may be as large as the entire reserves of the banking system. By the close of day, the banks must have regained their positive net positions with the Fed, and there is a great deal of trading of money back and forth on an overnight basis, to smooth out the jagged nature of payments made and payments received at unexpected intervals.

Much of this trading is done through brokers, on a more or less annonymous basis. Banks that have an excess of payments to them this day "sell" Fed Funds overnight to banks that have an excess of payments from them. Branches of foreign banks have access to FedWire—through the Fed does not permit them to run daylight overdrafts—and participate in the Fed Funds market. In 1981 and to an increasing degree in 1982, branches of Mexican and Brazilian banks, and some others used their access to this market to fund their nations' continuing and growing foreign exchange deficits. It is hard to get a handle on the numbers, but something more than $10 billion seems to be involved.

I asked a senior person at the Federal Reserve Bank of New York whether he hadn't noticed this rapid and very large growth of "takings" from the Fed Funds market by the foreign branches. "We noticed it," he said, and paused. Then he said, "I think it's fair to say we didn't think through what it meant." I asked the Treasurer of one of our half-dozen largest banks why he had continued to sell increasing quantities of Fed Funds to such purchasers. He said, "Well, they were paying an extra eighth . . ." For an extra eighth, the leading banks of this nation put in additional jeopardy the financial system of the world. For once the news was out, any responsible regional banker selling Fed Funds would be obliged—I think, legally obliged: he could be sued if he did any thing else—to remove the names of these foreign branches from the list of banks to which he permitted his broker or traders to offer his Fed Funds.

We have now seen for some months a disgraceful spectacle of the big New York banks, and, indeed, the Federal Reserve, leaning on our regional banks to continue the dangerous practice of selling Fed Funds to foreign purchasers who were using them for purposes quite illicit by the generally accepted terms and conditions of this market. The governor of the Brazilian central bank has just taken it upon himself in New York to threaten that banks that refused to resume their sale of Fed Funds to his wards will forever be barred from doing business in Brazil, a fate they may not consider as dire as he does. The fact is that this market was fundamentally in the custody of the large money center banks. The Fed did not supervise it; everyone believed that because they depended on it so largely—the New York banks as a group typically take more than $15 billion a night from this market—they would protect it. That confidence turned out to be misplaced.

To tell the regional banks that participated in the syndicated loans to Mexico, Brazil, Argentina et al. that they now must stay the course—in for a penny, in for a pound—strikes me as perfectly reasonable. They wanted to be part of the exciting world of international lending, and they have no right to back away when the game gets rough. But the banks who simply permitted foreign branches as well as domestic peers to buy their Fed Funds should be permitted to go home. They relied upon the money center banks to be keeping this market in good order, and they were entitled to do so. So far as I can find out, they didn't get the extra eighth—only the big boys got that. Now let the big boys cover: they made the mess, and they should clean it up. Certainly the Federal Reserve Banks and the Treasury Department should not prostitute themselves to the interests of the money center banks to keep the lesser fry in this dangerous game.

For the future, Congress should pass legislation restricting purchases and sales in the Fed Funds market to banks using this money for domestic purposes. Such legislation will be tricky to write, because there is an incessant arbitrage between the Fed Funds market and the London interbank market—but, after all, the Bank of England in this instance has every reason to wish to be helpful. A very eminent person whom I do not feel at liberty to quote said recently that he thought what we needed was a way to restrict ths market to banks that had a source of dollars other than a foreign bank. I leave the specifics to the technicians and the draftsmen.

Another matter that should be though on with the guidance of Congress is the excessive use of the dollar internationally as the denominator of several key commodities, especially oil and credit. In this country we believe that oil prices have been stagnant or declining for the past two years. But if we were French or Japanese or German, we would have not such belief, for the price of oil is up 40+percent in French francs and more than 20 percent in German marks and Japanese yen over the past 30 months. Oil is sold only for dollars, and the dollar has risen that far in exchange value with reference to these other currencies.

For the borrowers, whose export earnings are substantially denominated in other currencies, the appreciation of the dollar over the last 30 months has created a debt deflation. If their debts were in yen or marks or francs or pounds or Special Drawing Rights, they would be much better off. And while commodity prices have been depressed by the strong dollar—because a steady bid in other currencies has meant a lower bid in dollars—the interest on dollar loans has been atrociously high because of our domestic need to control inflation and the lack of other means for doing so.

The only hope to get well that today's troubled borrowers have is a severe and soon deterioration of the dollar. Given the merchandise trade deficit we will run this year, and the total lack of belief domestically that either the Congess or the President will get a handle on the budget, that hope may become reality. When the banks tell you that their economists have figures indicating that the borrowers can pull out all right, what they mean is that they expect the dollar to take a nose dive an inflation to resume at a brisk, probably double-digit pace in this country—before the lenders wise up and the interest rates soar again. I expect we can all agree that this a a hell of a way to run the raiload.

We have structured for ourselves a world in which all instabilities are exaggerated by the fluctuating exchange value of the dollar. Perhaps this is what Donald Regan sensed when he spoke wistfully of seeing whether that hotel is still on the mountainside at Bretton Woods. If there were more use of other currencies or Special Drawing Rights in international borrowing—and if the key commodities were sold for units of a basket of currencies rather than for dollars—other people's problems (and, by extension, our own) would be less terrifying to them (and, by extension, to us). If we come to adopt Professor Kenen's or Mr. Rohatyn's plans for stretching out the debts of the troubled borrowers, and I would certainly be on that side of the debate myself, I would hope that we do so with multicurrency loans rather than just dollars.

Much of our obligation to help in this crisis derives from the fact that the Federal Reserve followed policies that may have been domestically necessary—I find no fault with Mr. Volcker—without attention to the side effects of a strongly appreciating dollar and thus an increasingly heavy burden of dollar-denominated debt on the rest of the world. As we look around for ways to assure that we do not again find ourselves where we are today, we must seize the opportunity to take the dollar off center stage occasionally, and let it sing in the ensemble.

One such opportunity is upon us this year, when we will be borrowing very heavily in the international markets to finance a large current account deficit. It is of course very attractive to borrow in a currency we can print—the Brazilians would have no trouble at all if people would take cruzeiros in repayment of Brazil's debts. But there are long-range costs, of which the present crisis is only one example, in arranging the world so that our domestic policies so deeply influence what other nations can do.

From early on—and not as part of some emergency package to bail us out, like the one that was required in 1979—we should be financing some of this year's deficit in our international accounts by issuing Treasury paper denominated in currencies other than the dollar. Because interest rates are lower in Germany and Japan than here, the costs of borrowing in an appreciating currency would not be as great as they might seem. And by borrowing in foreign currencies from the start, we buy some insurance against a precipitous slide of the dollar such as we experienced in the late 1970's, as destabilizing in its way as the precipitous appreciation of the last 30 months. It might be helpful if members of this body—not, I suppose, this committee—could indicate to the Treasury that in the next resolution enlarging the permissible size of the national debt they will urge that some part of the increase be denominated in foreign currencies.

A final point. If it is American public policy to promote the development of poor nations, and I take it that this has been American policy since Harry Truman and Point 4, then the American taxpayer must be prepared to pick up a good piece of the tab. Many of today's troubles arise from government abdication of what were really governmental responsibilities in the 1970's—quite apart from all the true stories of extravagance, corruption, folly on the merry-go-round, the motive power was supplied largely by government efforts to duck this problem.

To the extent that a rescue must now be mounted, with government carrying a larger share of the load, everyone should keep the purposes in mind: (1) to reduce the debt burden on countries that can't bear it; (2) to prevent a generally damaging shrinkage in international trade; and (3) to assure that the banks will not be so "unlucky" as to do this to themselves, to the developing countries, and to the rest of us, all over again—next time with even bigger numbers, and perhaps more disastrous results.

The first objective requires a reduction in the interest rates these borrowers must pay—not unlike the reduction a well-run bank gives a troubled domestic debtor to tide him over his troubles. The second requires that new money made available to the debtor countries be spent for purposes other than making interest payments to banks. The third requires that banks not be permitted to pretend that unsound lending practice is profitable. I note without specific suggestion for legislation that all three purposes would be served by a rule to restrict the interest rates banks can charge when participating with governmental or intergovernmental agencies in the restructuring of sovereign debt.

Thank you.

[Response to Senator Heinz' written questions follows:]

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March 22nd, 1983

Dear Senator Heinz,

Thank you for giving me the opportunity to expand on my testimony. My answers to your questions are as follows:

1. What would be the impact upon banks of a requirement to establish additional loan loss reserves at the time of rescheduling?

The first obvious impact would be a decline in bank profits as reported currently--not necessarily in real bank profits over time. The argument that this would "require" banks to charge higher interest rates to other borrowers strikes me as entirely specious, resting on the banks' belief that they are the only lenders. They are not. They must compete for industrial business and financial business with the commercial paper market, for consumer business with the finance companies and mortgage bankers. That competition is now sturdy enough, I think, to hold down bank interest rates over time.

The second impact would be the creation of a margin of flexibility for the further negotiations on these troubled foreign loans. The borrowers must one way or another be given some relief from the interest burden. Banks are entirely unwilling to provide that relief today (indeed, they seem bent on increasing the interest burden, which is bad banking in addition to all the other things wrong with it). The justification for their reluctance is that any reduction in income from these loans would "impair capital" (not necessarily true, as the losses can be covered from current income, too). If reserves were higher, the losses could be taken from reserves, and the negotiations could proceed on a more realistic and--from the point of view of the world economy--more fruitful basis.

It should be noted that the drop in demand for American exports that everyone stresses is the result of the need to use every dollar that comes into the country to pay off the banks. If interest payments declined, effective demand for American exports would rise. This is a far healthier way to promote American exports than exponential lending, blowing up a balloon that must ultimately burst.

2. You stated that you supported a law which limits a bank's lending to specific countries. What are the negative aspects of such a plan?

Obviously, such a requirement would have to be phased in gradually, or the effects in borrowing nations would be horrendous. In the long run, it would reduce U.S. lending to the largest foreign borrowers. The argument in this corner is that by requiring banks to improve their credit judgment--choosing more carefully among requests for loans from foreign sources--the limit would probably help rather than hurt both borrower and lender. Anything over the limit that seems desirable can and should be provided by international public lending authorities, not by banks. Moreover, if banks wished to operate through subsidiaries in the borrowing countries--lending in the local currency rather than in dollars--they could escape the lending limit as I defined it. This would be a far healthier way for them to proceed, on all counts. If they wished to assume dollar liabilities to fund those loans, it would be their dollar exposure rather than the borrower's, which is in every way correct--and turns out to be what happens anyway.

3. How would you perceive such a country lending limit to work?

As domestic limits work. A percentage of capital should cap the loans that can be made to the combination of private and governmental borrowers which are dependent for dollars upon a foreign central bank. The requirement would apply only to dollar-denominated loans. Exemptions from the limit could be given when the loan is guaranteed to a U.S. or third-country corporation that has access to dollars from sources other than the foreign central bank. I think a case could be made for additional exemptions when the loan is part of a project funded in part by an international public lending agency--IADB, World Bank, etc.

4. Congress would set the limits, as it does domestically.

5. The U.S. bank regulators would enforce them.

6. What are the implications of ever-increasing commercial bank exposure to LDCs?

Very briefly: it increases foreign trade and corruption in foreign countries; it boosts reported but not necessarily real bank profits; it diminishes the overall sturdiness of the international financial system; it stimulates inflationary pressures worldwide; it gives hostages to fortune from the U.S. government to both the banks and the borrowing nations; it involves bank regulators in foreign policy questions which are none of their business, and State Department personnel in banking questions which are none of their business.

7. Is there an absolute limit of lending to LDCs which we may be approaching--or already reached?

The limit in a well-ordered world would be not on lending but on borrowing--that is, can the borrower afford to carry the debt? And the question must always be asked: is this loan designed to increase future GNP, or is it a mortgage on future GNP for the purpose of supporting current consumption? The former is probably supportable even in the heavily indebted countries; the latter is a bad idea even when the borrower is a Sweden or a Denmark, an Ireland or a France.

I have not edited your transcript yet. To choose my adjective carefully, it is a lousy job. This is in large part my fault, as I talk too fast. I can probably find time between two and four in the morning later this week to do that task, if there is still time. Could you ask someone to call me and tell me if you can still take changes? I am awfully busy--and when I'm not at my typewriter nobody makes a living for me--but I guess the record is the record and one should care.

Thanks.

Sincerely,

Martin Mayer

Senator HEINZ. Thank you very much, Mr. Mayer. I think both you and Mr. Champion have given us quite a bit to chew on and think about.

With respect to the very last point that you made, Mr. Mayer, you suggest that the banks should take a lower interest rate on refinancing, rather than the higher rate that they are now paying.

Mr. MAYER. Yes, as they do with Chrysler and just as they would with a troubled borrower when they feel a commitment to help. That's right.

Senator HEINZ. How would you respond to the argument, which I'm sure we'll hear from the next panel, that while this is riskier, we made loans at an interest rate that was really too low in the first place.

And furthermore, we won't do it if we don't get a higher interest rate.

Let's start with the last point, which is they won't do it if it isn't made more profitable.

Mr. MAYER. I cut a phrase in my prepared testimony, because it seemed to me unnecessarily unpleasant, but let me revive it and say it right, since I wrote it.

Senator HEINZ. What page are you on?

Mr. MAYER. At page 5 at the bottom.

What many of the banks have been saying boils down to a peevish threat that if they are made to pay for their mistakes, even the least little thing, they will commit suicide and then we will be sorry.

You wouldn't accept that argument from your children, and you shouldn't accept it from the Chase Manhattan Bank. [Laughter.]

Senator HEINZ. Sounds like they are saying, rather the position of the young man who kills his parents and then throws himself on the mercy of the court claiming he is an orphan.

Mr. MAYER. If the banks lend money at inadequate interest rates, that is not the taxpayers' problem. They have a great stake in not having borrowers say, turn their pockets inside out.

BANK SOLD MONEY AT PREPOSTEROUS SPREADS

Everyone of the people who is going to testify before you has a bank with a foreign lending department and a quota which it was supposed to fill. They went out and they sold money; they sold it at preposterous spreads. They kept telling the world that they were selling it at preposterous spreads. They kept saying the spread was too narrow. They did it. It is their problem.

Perhaps in the real world if the spreads had been a little greater there might not have been so much borrowing. But certainly, for them to profit from the series of mistakes—and yes, the recession hurt and they wouldn't have been quite so badly off without it. But Argentina was about to reschedule before it invaded the Falklands. And, these are banks making bank loans with other peoples' money. These are not equity investors supposedly making a judgment about the future prosperity of something they are buying into.

They are supposed to have very substantial margins of safety. And so far as I can see—and I have been looking at this now for 10 years—they did not go after those margins of safety, they went after fulfilling the quota. They made the loans.

I don't think that they ought to be punished, that they ought to go bust, but I don't think that they should now appear to be profitable.

Senator HEINZ. Now the Federal Reserve, Chairman Volcker and others have been in the forefront of getting our banks to reschedule. Clearly when the Mexicans and our banks sit down together, the Mexicans did say, have said, will continue to say, we don't want to pay more interest on our debt. Yet, our Federal banking authorities have been in the business of encouraging a settlement where they still have a very big voice in what exactly our banks do settle for.

Is it your view that the Federal Reserve has not been aggressive enough in forcing American banks to take a reasonable interest rate?

Mr. MAYER. It is hard to say that the Federal Reserve has that authority.

Senator HEINZ. It has a lot of influence.

Mr. MAYER. I happen to agree with you, but they don't. They have the concern that you have, that if these guys aren't permitted to show considerable profits on these things they won't do them, and that there is nothing that the Fed can do about it.

The days of regulation by lifted eyebrows seem to be over. I don't know exactly what has caused the decline. One reason must be the ease of access into the banking business from all sorts of corners. Another is the fact that we have moved from banking to money brokerage, so that the control of bank liabilities no longer has the same effectiveness that it once did in the Feds' operation.

I do not think the Fed approves of the fees and the interest rates that are being charged to the troubled borrowers. I think the Fed does not feel it now has authority to move in this area. I do not think they approve of it.

Senator HEINZ. Let's make the stipulation that everything we are talking about is prospective. We don't want to, at this point, try to undo something that has been done with great difficulty. But maybe—does that suggest that we should give the Feds some kind of much more explicit authority and mandate in the future, should there be a recurrence, to give them not only the authority, but whatever leverage they need to make that influence good and thereby make it clear today to banks that overextend in the future that it is not going to be very profitable. In fact, it could be less profitable.

If that is right, how would one write that?

Mr. MAYER. I would expect that you are talking about a situation that where the condition of the sovereign debtor is such that some sort of restructuring with governmental or intergovernmental help is required. Then the Federal Reserve should have the power to put a ceiling on fees charged, should have the power to put a ceiling on the interest rates charged.

Senator HEINZ. That sounds to me like an excellent suggestion, and we will consider that very seriously.

NO LOANS TO FOREIGN GOVERNMENTS

Let me ask you another question. Mr. Champion in his very good remarks says, "Commercial banks should not lend to any foreign government ever, under any circumstances."

I think his fear, if I understand him correctly, is that that is really development financing of big projects, by another name. It does not result in real economic development; it has a tendency to go into large, massive Government projects; perhaps the moral equivalent of the powerplant in Zaire which turned out to be an exercise in futility.

Do you agree or disagree with Mr. Champion?

Mr. CHAMPION. I don't think the banks should be lending somebody else's money, as Mr. Mayer said, to governments, foreign governments.

Senator HEINZ. I understand that. I am interested in how Mr. Mayer would react to that, because it is my understanding from his testimony, he would not proscribe it. I wonder why.

Mr. MAYER. I would not proscribe any loan which generates, either through the creation of export industry or import substitution, the promotion of revenues to pay it off internationally. Except, I think individual banks should not go over a certain ceiling.

What has been troublesome in recent years to me, is not the lending for projects—and here we are dealing again with the abdication of governments and intergovernmental bodies. Banks get into this because the guys who should have been doing it weren't, in part. But the lending that has been done for current consumption which does not produce an earning stream later to repay the loan, or the lending that was done and to which you made glancing reference in the interest of what someone in England called the kleptocracy, the government of thieves, where the money that is being lent wends its way back here into condominiums in Vail and Florida.

And the banks had really no way to police this—it is a question of whether they had an interest in policing it—whereas presumably the governmental bodies have a little more clout in that regard.

So, I would not in the least be against project lending by banks to governments provided that the thing is within the capital limits, and provided that they release the money gradually as a good bank would to a good builder as the project gets done.

Senator HEINZ. I noted that suggestion.

Let me ask Mr. Champion this: Mr. Mayer has made a number of suggestions, and you, Mr. Champion, are the retired chairman of the Chase Manhattan Bank, one of the major banks of the United States and the world. I would like to get your reaction to some of his suggestions.

One is that banks should amortize their syndication fee over the life of the loan. Can't banks just get around that by writing 90-day loans?

Mr. CHAMPION. It would be difficult to adjust the fee or get a reasonable fee for a 90-day loan. I think his idea is perfectly sound. But that is not of a major problem, in my opinion.

Senator HEINZ. You think it is all right to write a regulation that will do that?

Mr. CHAMPION. I don't believe in more regulation, frankly, Mr. Chairman. I think the Federal Reserve and the Comptroller's Office have all the authority they need. They are the ones that should be really taken to task for not stepping on this thing earlier.

I talked to both of them about this in the past years. They realized there was a problem developing.

Senator HEINZ. I happen to agree with you. We are told, as I imagine you are, that they are unsure of whether they have the power, and they are unsure as to what their mandate is to use it. And whether we agree with them or not, clearly we are going to have to stiffen their backbone in the future.

Mr. MAYER. They are unsure whether you and the Congress will back them up if they get in a fight with the banks.

Senator HEINZ. That's been true in all kinds of other areas in the Fed, it comes to mind. A lot of people argue that there is really some considerable ambiguities there.

Let's keep going.

Another proposal that Mr. Mayer makes is that these loans should be classified—this is on page 4 of his testimony—in a way that reduces bank profits. He says:

> These renegotiations are troubled debt restructurings. As such they are covered by the Financial Accounting Standards Board Standard No. 15, which requires that interest received be used to reduce the principal of the loan rather than taken into income.

And in effect, that this should be treated rather differently than it is now.

Do you agree with that, his suggestion at pages 4 and 5?

Mr. CHAMPION. I don't have pages 4 and 5 before me. But, basically, the Federal Reserve and the Comptroller have a perfect right to rate the loans, they can appraise the loans and use their own judgment as to what that rating is going to be.

My own suggestion was, when I wrote this article in the Wall Street Journal, that all nonconforming loans be written down at least 50 percent of their face value. And that in addition to that, reserves for bad debts be increased as Mr. Mayer suggested. I suggested a quarter of 1 percent, until it reached at least 3 percent, perhaps 5.

I think there have been some earnings shown that they were rather unjustified. Conservative bankers in many sections of the country have done a different job in that.

Senator HEINZ. We are going to hear from the bankers next, and undoubtedly they are going to tell us that the sky will fall if we do that. They won't like that.

What would you say to the panel we are about to hear from when they tell us that this would be precipitous, dangerous, and terrible for us to do.

Mr. CHAMPION. When you have a problem, if you are going to not face it realistically and frankly, you are in a very serious position. This can be solved if we are willing to meet this head on. If we are willing to say that our earnings haven't been conservatively used—let's use these earnings to establish the reserves that we need so badly in terms of writing down loans. The banks have a larger problem—this year they are showing a larger percentage, or a larger number of nonconforming loans—and they are basically domestic loans, not the foreign loans—than they did before.

Now if they mark that down to 50 percent and they get it back later, that's fine. If they start to build up their reserve for bad debts which is by law limited to—pretax basis—by law limited to 1 percent——

Mr. MAYER. Less now, six-tenths of 1 percent.

Mr. CHAMPION. At any rate, one or the other: Neither one is appropriate.

And yet your Comptroller's Office, I know, criticized a bank that took all their bond losses for 2 years, wrote off all their nonconforming loans, had a reserve for bad debts of 2.6, and they said, "You are not showing enough earnings."

That's where you need managerial change, and that is where we need people that are going to run these things properly. You could never legislate to satisfy everybody or to control everything properly.

Senator HEINZ. Mr. Champion, my time has expired. Thank you.

Senator Proxmire?

RECYCLING PETRODOLLARS INTO LOANS TO LDC'S

Senator PROXMIRE. Mr. Mayer, how do you react to the argument that the witness and the banks and others give us that after all the banks have done a statesmanlike job, and a job certainly in the national and international interest by recycling petrodollars into loans to LDC's, which they have done to a considerable extent.

What is your reaction to that?

Mr. MAYER. I think there is a good measure of truth to it. I think that the governments were unable to move fast enough when the crisis came in the early 1970's, and the banks were able to move fast enough. I think they are—it was made relatively easy for them by the arrival of the deposits that had to be lent out.

Nevertheless, I think as you look at the period 1973 to 1975, while you can see that the incipient troubles are there, you can also claim a degree of activity on behalf of the international system. If you look at the last 3 years, and you look at increases of 30, 35 percent a year in lending to Mexico at a time when the Mexicans knew perfectly well this didn't make sense, then you are getting into an area where it just got beyond any rational calculation.

I think that they were still thinking in the early 1970's about how they were going to pay it back, get it paid back. By the end of the decade they were saying, well, it clearly can't get paid back anyway, maybe it can be serviced. And if worst comes to worst, of course we have a Government to bail us out.

In the hearings on the Witteveen Facility back in 1977, on the amendment to the Bretton Woods Act, the comment was made by one of your colleagues that the banks were all relying on the notion that if somebody gets into terrible trouble the Government will come and make sure that nobody gets hurt.

They relied on that increasingly and what troubles me now are two worries. One is that they will now just go away and things will collapse. There are dangers here. And the other is that they will be encouraged to do it again.

And the next time around there will be no way to keep it from collapsing.

You really have to walk the line making sure that we don't, in fact, destroy the international trading system now. And at the same time that we don't create the preconditions that are inevitable to destruction 6, 7, 8 years down the pike, by letting everybody feel that, gee, that's a smart way.

Senator **Proxmire**. The other part of that question, of course, is that they also argue the situation that developed was very hard to foresee. After all, you had a tremendous drop in commodity prices, you've got a worldwide recession, and it was probably of a far more severe nature than foreseen by forecasters and others.

Mr. **Mayer**. Yes. But when it began to look bad in 1979, 1980, they could have cut back then and everybody would be better off today. Nobody could have imagined that the dollar would continue to appreciate through 1981 or 1982—it did through a good chunk of 1982.

My feeling is that the responsibility of this Government derives to some extent from the activities that were taken for domestic reasons that have a profound international impact on the appreciation of the dollar, which has made the debt burden very much greater.

Once again we talk about commodities. If there is a commodities index, it hasn't gone down that much in terms of other currencies. The commodities are all denominated in dollars, part of our problem comes back to that.

I think you could justify the banks pretty much through the end of 1979, and maybe well into 1980. When we get into 1981, and the first half of 1982—and after all, all of these things get to be extremely troublesome at the margin, it is the last $10 billion that is unmanageable—and they just kept rushing in. The water was pouring in and there was no effort made to build a dam.

Senator **Proxmire**. Mr. Champion, you say at the beginning of your testimony, and it is a theme that runs through it—you say the debt of non-OPEC developing countries is reported to be over $500 billion with no tangible evidence that living standards have improved.

Isn't it a fact that the OECD figures show that the growth of these underdeveloped countries has been almost phenomenal in the last 10 years or so. It is the borrower that pays the growth in the developing countries by a ratio of say 5 to 1. There has been remarkable economic progress made.

And the situation as you point out, may be modeled in Taiwan, Korea, and a few other places, nevertheless there has been that growth. What they do with it in terms of distribution, of course, is a function of their political system. We can hardly hold bankers or any others to blame outside their country.

But hasn't this achieved a constructive and useful purpose in helping these countries grow?

Mr. **Champion**. Senator Proxmire, that's a very grave question, in my opinion. When you see that they are saddled with such a horrible debt, tremendous debt, it is going to take a very difficult readjustment period for them.

Let's look at the people themselves. You haven't seen basic improvement. Take Mexico, you have seen a tremendous increase in the governmental expenses. They have been investing in the petrochemical, they have been investing in steel mills, things that are not really giving the jobs to the people, or the education and training.

I think basic changes have to be taken. Even though you can say, sure, they are producing more, but is that really the economic thing for them to do, the best for their economy and their people.

DOUBTFUL REPAYMENT OF FOREIGN LOANS

Senator **Proxmire**. Let me ask you, Mr. Mayer, some experts challenge the notion that we have only a liquidity problem here, and say we have a solvency problem. They say that the countries will never be able to repay their debt, it must be stretched out at reduced rates.

What's your view about that?

Mr. **Mayer**. I agree with that. It must be stretched out at reduced rates.

Senator **Proxmire**. Then who takes the loss, the banks or do we have to step in with some kind of supplemental——

Mr. **Mayer**. It is going to be split.

Senator **Proxmire**. Why should we split it?

Mr. **Mayer**. They can't carry it all.

Senator **Proxmire**. The banks can't carry it all?

Mr. **Mayer**. No, it is really too much now. As I said, there are two areas of perfectly valid defense; one is they went in because the Government didn't go into things that the Government should have gone into. They also went in because they were pushed by their biggest accounts in many instances.

And the second is that they worked in dollars which became increasingly more difficult for people abroad to pay back. You can't solve the liquidity problem by increasing people's debt service charges. You can't. It is not going to happen.

If it is just a liquidity problem then what you have got to do is reduce their debt service charges and make them more liquid. You can do this by stretching out—I was, as you know, of two minds about whether Mr. Rohatyn could pull off what he pulled off in New York City, when he set up something that was clearly illegal, but it turns out you get a year before you find that out.

The sort of thing that he did there, that was very rewarding to the banks, sort of a de facto bankruptcy that isn't a bankruptcy, de facto default that isn't a default, that keeps the paper apparently good, reduces the earnings on it to the greatest extent that you can manage, and reduces the burden on the borrower to increase the hope that someday he will be able to carry it.

But, to keep lending the money to pay the interest, and they then have to pay additional interest on the money they borrowed to pay the interest—that is not going to work right, even if the economies pull out reasonably well.

It is going to work only if the dollar inflates and depreciates to such an extent that this debt burden becomes in real terms very much smaller. That is a very undesirable result. Almost as undesirable as having the whole thing go whoosh tomorrow.

Therefore, I think some sort of allocation of the losses which are there—if there is a solvency problem—between the borrower, bank, and the OECD government, have to be worked out. And certainly pretending that there are no losses——

Senator **Proxmire**. Any idea what the sizes of these losses are?

Mr. **Mayer**. That would depend, of course, as we said, on the growth of the world, the economy.

I think the answer to that is no. Anybody can make a ballpark guess, and I could, too. If you are talking about the major troubled countries, Zaire is obviously gone. Unless you can get hold of some of the bank accounts in Switzerland, you are never going to get that money out of Zaire. We tried now with a whole series of IMF strictures.

Poland may be gone.

Brazil certainly is not gone.

Mexico is in large part a domestic problem of how they conduct their own business, and whether they can in fact get Mexicans to invest in their own economy. If everybody with money in Mexico sends it out of Mexico, then it is extremely difficult to do much for the Mexicans.

So that all of these are individual cases.

Argentina I should imagine one would want to assume considerable loss. No talent for self-government in that country, never has been.

Brazil I can imagine that over time, probably no loss.

Mexico is up in the air.

OK?

Senator **Proxmire**. Mr. Champion, you wrote a very interesting article for the Wall Street Journal on January 11, entitled "Foreign Debts, a Proposal for U.S. Banks."

And you made four particular propositions. I would like to ask you very quickly about each, and if you would affirm them and if you feel they apply in this case.

First, immediately discontinue any further bank loans for the developing and iron curtain countries unless they are fulfilling a specific commitment.

Do you stand by that?

Mr. CHAMPION. Absolutely.

Senator PROXMIRE. Two, the examining authority should suggest for the next 5 years the bank dedicate at least 50 percent of their pretax earnings toward writing down their nonconforming loans to no more than 50 percent of the face value.

Still would apply?

Mr. CHAMPION. No other way of doing it.

Senator PROXMIRE. No. 3, the examining authority should suggest that dividends not be increased and should look with disfavor on any purchase by the bank of other institutions that would further lower their ratio of capital to total assets.

Mr. CHAMPION. Never have had as low ratio of capital to assets risk or anything else as we have today.

Senator PROXMIRE. And finally, if present American banks are allowed to have reserve for bad debts only equal to 1 percent of their loan, you suggest that that be increased at the rate of one-quarter of 1 percent on an annual basis until it reaches at least 3 percent, and preferably 5 percent, although you wouldn't apply that to all banks, but particularly to banks making foreign loans.

Is that right?

Mr. CHAMPION. I think that's fair. There is nothing wrong with that. It gives a security to the banks which——

Senator PROXMIRE. The reason I said the last is unreasonable, the next paragraph is, "obviously this program isn't essential for all banks, but it certainly should be adopted by those banks who have loans for developing and——"

Mr. CHAMPION. That's true. In terms of reserve for bad debts. I think that is perfectly legitimate.

Senator PROXMIRE. You would apply that universally?

Mr. CHAMPION. Universally.

Senator PROXMIRE. Mr. Mayer, do you agree with those four points?

Mr. MAYER. I think the numbers are too high.

Also, you have made it difficult for the bank to accumulate loan loss reserves. The law now limits what they can take out of pretax earnings for that purpose.

My understanding is that this year the IRS says that anything that would increase the loan loss reserves over 0.6 of 1 percent has to be done out of posttax earnings.

I think that is a mistake, I think that we want to encourage them to take larger loan loss reserves, particularly since they now account for them by deducting them from the loans rather than putting them into Mickey Mouse capital on the other side of the balance sheet.

I think the Congress as one of its steps this year in this matter, should sacrifice some tax revenue. The banks don't pay a great deal in the line of taxes. But nonetheless, still I think the Congress should be encouraging banks to beef up the loan loss reserve by changing the tax laws so as to sacrifice some small amount of Government income to beef up those reserves.

Senator PROXMIRE. Mr. Chairman, I recognize the hour is late, and you have two other Senators who want to question this panel, I'm sure, and you have another good panel coming up——

Senator GORTON. Mr. Chairman, I don't have any questions.

Senator PROXMIRE. At any rate, the hour is late, I have to go to the floor.

Senator LAUTENBERG. I think the questioning is almost as brilliant as the statements.

Senator PROXMIRE. I would like to ask unanimous consent to have my further questions answered for the record.

Senator HEINZ. Without objection.

And I have some questions that I am going to submit to both of you gentlemen. I would appreciate, if you can, if you will answer them.

Senator LAUTENBERG. I must, Mr. Chairman, compliment each one of you on not only a good, logical presentation, sprinkled here and there with a degree of reality that I think is called for, and humor as well.

Thank you.

Senator HEINZ. Gentlemen, thank you.

Our last panel consists of Mr. Richard Debs, Mr. William McDonough, and Mr. George Clark. I would like to ask Mr. Debs to lead off, please.

STATEMENT OF RICHARD A. DEBS, PRESIDENT, MORGAN STANLEY INTERNATIONAL, INC., ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY FRANK E. BRIBER, JR., VICE PRESIDENT, ALLIS-CHALMERS CORP.

Mr. DEBS. Thank you, Mr. Chairman.

I am appearing here this morning as a representative of the U.S. Chamber of Commerce. I am the chairman of the Subcommittee on International Economic Development.

Accompanying me is Frank Briber, who is also a member of the subcommittee, and vice president of Allis-Chalmers. And he brings to these proceedings a perspective from the point of view of a major U.S. corporation involved in international trade. He has a brief statement which we would appreciate, with your permission, submitting for the record.

Senator HEINZ. Without objection.

Mr. DEBS. I might say that I am president of Morgan Stanley International and managing director of Morgan Stanley & Co., an investment banking firm.

Prior to joining Morgan Stanley several years ago, I spent about 16 years with the Federal Reserve Bank of New York, and left there as the first vice president and chief administrative officer. So I have some—although I am not a commercial banker and not involved in commercial bank lending—I have some extended experience as an observer, both as an investment banker and a central banker.

I will summarize the statement which we are submitting for the record, and try to highlight some main points from it, as well as some points that I would like to refer to in response to the discussion that you had this morning.

I might say at the beginning, the U.S. Chamber welcomes this opportunity to testify in support of the IMF, and to urge prompt congressional action to approve the administration's request for an increase in its lending resources, both through a quota increase and an expansion of the GAB.

The U.S. Chamber believes particularly at this critical time, that the IMF should have sufficient resources to carry out its responsibilities for maintaining a stable international financial system, which is really essential to the attainment of U.S. economic, political, and security objectives.

I think it is clear that today in this interdependent economic world the health of the U.S. economy and the global economy cannot be separated. U.S. growth and employment are promoted by expanded international trade. With 12 percent of our GNP now related to international trade, the U.S. economy is clearly dependent on maintaining a smoothly functioning international economic system and healthy trading partners.

IMF UNDER SEVERE STRAIN

As you well know from these hearings, at this moment, for a variety of reasons, the international financial system is under severe strain. The problems that face us must be managed effectively if the free world is to avoid large-scale economic disorders.

The IMF was created under U.S. leadership, and I think a point important to stress, is under continuing U.S. leadership, to play a major role in dealing with these kinds of problems. In many respects it is uniquely suited to do so, provided that its resources are adequate to the task.

I won't try to describe here what the role of the IMF is, but I think it is worth noting that it does two basic things, in very simplistic terms.

First of all, it provides money; short-term financial assistance. But second, and much more important I think, is that it plays a leading role in formulating a program for a borrowing country designed to restore long-term economic viability. And in this conditionality of the IMF serves as a catalyst for attracting additional funds, both from official and private sources, to further insure the ultimate success of the program.

In this sense I think the IMF is unique. There is no other source of funding, whether private or public sector, governments or what have you, that has the ability to impose these kinds of conditions to attempt to achieve what is in the interest of all of the members of the IMF.

Much has been said on the monetary and financial and economic impact of the action that we are supporting on the U.S. budget. That subject has been covered. As you know, it requires congressional appropriations and authorization, but doesn't result in net budget outlays. Of course, it does have a cost, there is no doubt about that, and that was discussed this morning. Mr. Chairman, you brought it up yourself.

Clearly the main impact is on the capital markets whenever the Treasury is required to raise the money, raise the funds to meet its commitment. Now that impact clearly is something that we should be concerned with. But basically the ultimate adverse effect in my opinion is higher interest rates. To the extent the Government wants to borrow more, the pressure is up; in the absence of such borrowing that pressure would not be there.

I was interested in reading Secretary Regan's testimony yesterday and the analysis he had of the impact on the budget, and the U.S. borrowing requirement. And put into that perspective, I think, while certainly this increase in the potential borrowing requirement is not a minor amount, but nevertheless, compared to either the borrowing requirements on an annual basis, or the total public debt outstanding, it is a relatively—relatively— small amount. But there is no doubt that this is not a cost-less program.

However, in our opinion, while there is a cost involved in solving this problem, we think that giving the IMF this additional strength is the most cost-effective way to achieve the objective that we all share.

Why is it worth this cost?

IMF PROGRAMS FOR ADJUSTMENT

Well, the IMF serves United States' interests in several ways. First, because it has these programs for adjustment. The health of the world economy obviously is important to the United States. Simply to repeat some figures that have been mentioned many times but are well worth repeating.

Over 20 percent of all industrial goods produced in the United States is exported.

Forty percent of our agricultural production goes overseas.

Trade as a portion of gross national product has more than doubled over the past ten years.

In the developing world itself, exports to the developing world are a major part of this picture.

Secretary Olmer has given you figures which, again Mr. Chairman, you have focused on, on the impact of the last years' experience on U.S. exports to countries like Mexico and Brazil. And, as you say, it is very difficult to disaggregate those figures and to see exactly what is attributable to their debt burden, or what is attributable to the world economy, what is attributable to high interest rates, what is attributable to the high dollar, and it is difficult. I have no way of doing it myself.

But the point is that all of these factors have contributed to the problem we have today. The world recession is a cause of the problem we are discussing today. High interest rates are a cause as well. However you may split that up, the point is we have seen over the last year, because of the world problems we have had, including the debt burden, the lowering of U.S. exports to these countries.

I might just for a moment, pickup the point that has often been mentioned about the severe austerity programs— severe or not, the austerity measures that the IMF insists upon in its program of conditionality, and the argument that because of these requirements U.S. exports will be affected adversely. That is, they will be reduced.

As we have seen this morning, everyone acknowledges that they will be reduced as these IMF programs go into effect. But that is somewhat misleading. The question is not whether the imports may be reduced somewhat as a result of the IMF program; the question is how drastically they would be reduced or will be reduced in the absence of such a program.

Given the state of economies of these countries, it is clear that if there were no IMF programs, their ability to import would be drastically cut back. And, if the objective is to try to maintain import levels as close to normal as is feasible—which is an IMF objective—the IMF approach is the best option we have available.

Another point I would like to stress is that the United States itself exercises great leverage within the IMF. As you know, the United States is, in effect, a major shareholder, a controlling shareholder. The way the voting powers are distributed, it really has the veto power. If you look at it in terms of ratios, it has a leverage of about one to five, in total IMF resources or in voting power.

On top of this, the IMF itself exerts considerable leverage. The case of Brazil is a good example. They have agreed to undertake a number of policy changes to qualify for the IMF financing. The IMF is putting in about $1.5 billion, and that $1.5 billion is serving as a catalyst to hold together a total package in excess of $26 billion, which includes about $4.5 billion in net new medium-term commercial lending.

So the point, I think, is the United States within the IMF has considerable leverage. The IMF itself, in putting together these resources subject to conditionality, has additional considerable leverage.

Another point that I think is important is that the IMF has proven itself to be an effective instrumentality. In general I think there would be agreement that its record of performance has been very good.

Under its mandate, it is not an aid agency. It lends money. It doesn't make grants. Resources are supposed to be repaid. The conditionality programs are designed toward that end. There has never been default.

NOT A BAILOUT FOR COMMERCIAL BANKS

Another point mentioned in my testimony, that I would like to give passing reference to has certainly been discussed over the course of these hearings and other hearings in the Congress, and that is this question of the IMF program being a bailout for commercial banks.

As Chairman Volcker has said, this is a "bail-in" for the banks. They have been very much involved in the process. They must continue to be involved in the process. In the long run, if these programs are successful, no doubt commercial banks will benefit. But, so will the borrowing countries, so will the international financial system, and so will the U.S. industry, agriculture, and labor.

In many ways it is very unfortunate, Mr. Chairman, that we have to be discussing this question at this time, requiring an additional financial commitment by the United States when we have such hardship and constraint in our own economy. The timing is not good. But the circumstances, and mainly the current worldwide recession, have drawn us to this point.

We have a problem, we must face it. We are in a box. We have to do something, and it must be resolved because it has a direct impact on the U.S. economy.

We don't think we have many options available. To do nothing in these circumstances would have serious adverse consequences for the free-world economic system, our general political and security goals, and in a very direct way on the U.S. economy itself.

For these reasons, the U.S. Chamber supports the proposals you have under consideration for strengthening the resources and the role of the IMF as one of the best options we have available for the problem. It may not solve the problem entirely, but if we don't take this step there is no doubt that it will compound itself and indeed become unmanageable. Thank you, Mr. Chairman.

[Complete statements of Mr. Debs and Mr. Briber follow:]

STATEMENT
on
THE INTERNATIONAL MONETARY FUND
before the
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
of the
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Richard A. Debs
February 15, 1983

I am Richard A. Debs, president of the investment banking firm of Morgan Stanley International, and managing director of Morgan Stanley & Co. Prior to joining the firm in 1976 I was the first vice president and chief administrative officer of the Federal Reserve Bank of New York. I am chairman of the International Economic Development Subcommittee of the Chamber of Commerce of the United States, on whose behalf I am appearing today. Accompanying me is Frank E. Briber, Jr., vice president of Allis-Chalmers and Kathryn Young, director, International Economic Development Policy at the U.S. Chamber. Mr. Briber, who also serves on the Chamber's subcommittee, represents a major U.S. corporation directly involved in international trade. The Chamber of Commerce of the United States is the largest federation of business and professional organizations in the country, and is the principal spokesman for the American business community.

The U.S. Chamber welcomes the opportunity to testify in support of the International Monetary Fund (IMF) and to urge prompt Congressional action to approve the Administration's request for an increase in the IMF's lending resources, both through an increase in quotas (member deposits available for IMF loans) as well as an expansion and enlargement of the General Arrangements to Borrow (GAB). The U.S. Chamber believes that at this critical time the IMF must have sufficient resources to carry out its responsibilities for maintaining a stable international financial system which is essential to the attainment of U.S. economic, political and security objectives.

In this interdependent economic world, the health of the U.S. economy and the global economy cannot be separated. U.S. growth, employment, industrial competitiveness and higher living standards are promoted by expanded two-way international trade. With 12 percent of our own gross national product now related to international trade, the U.S. economy clearly is dependent on maintaining a smoothly functioning international economic system and healthy trading partners.

At this moment, for a variety of reasons, the international financial system is under severe strain because of the problems faced by a number of developing countries in meeting their debt service requirements. These problems must be managed effectively if the free world is to avoid large-scale economic disorders. The IMF was created, under U.S. leadership, to play a major role in dealing with these kinds of problems, and in many respects is uniquely suited to do so, provided that its resources are adequate to the task. It has always been anticipated that IMF resources would be increased as the world economy expanded, and the present proposals for an increase are in many ways part of that normal process -- albeit with a sense of urgency created by the current problems in the world economy. Thus, the proposals you are considering are most timely, and the U.S. Chamber supports prompt, favorable action on them. The strengthening of the IMF at this time is one of the most cost-effective ways in which the United States can insure the stability of the system and the attainment of our own economic goals.

The Role of the IMF

The IMF was established to promote a sound financial framework for the world economy. It does this in two ways. First, and most obvious, by providing necessary short-term financial assistance. Second, and perhaps even more important, by playing a leading role in formulating a program for a borrowing country designed to restore its long-term economic viability and its creditworthiness. The "conditionality" attached to an IMF lending program, in turn, serves as a catalyst for attracting additional funding, both from official and private sources, to further the ultimate success of the program.

The IMF has a revolving pool of funds that any of its 146 member countries may draw upon when needed for temporary short-term balance of payments purposes. These funds generally are conditional on policy adjustments designed to restore a country's external payments to a sustainable basis. The ability to attach such conditions to its lending makes the IMF unique among international financial institutions. IMF conditions are designed to ensure that its funds will be repaid, in accordance with a commercially recognized debt servicing schedule, and that the country's balance of payments adjustment will be smoothed, allowing it to avoid drastic restrictions on its trade and payments or other measures that would be disruptive to open international economic relations.

In fulfilling its responsibilities in this current period, the IMF has played a major role in seeking to moderate the severe financial problems that currently are straining the international financial system. In recent months several very large developing countries, including Mexico, Brazil, and Argentina, have experienced serious liquidity problems which have necessitated reschedulings as well as emergency infusions of new funds from commercial banks, governments and official institutions. Over twenty other countries are having difficulty in meeting current payments on outstanding loans. Faced with problems in meeting these obligations, many countries have turned to the IMF for assistance.

This unprecedented demand on international financial resources derives from the severity of the world recession in conjunction with weak commodity markets and a decline in world trade. The heavy borrowings in commercial markets, undertaken by many developing countries to sustain ambitious investment programs, have proved in some cases to be difficult to manage in the face of declining demand for their exports coupled with the high interest rate costs of servicing their debts.

If the IMF is to continue to be effective in assisting member countries to overcome their debt servicing and balance of payments problems, it will require a significant increase in resources this year.

The proposed resources increase would consist of two parts:

- an increase in quotas of 47.5 percent as recommended by the IMF's Interim Committee at its meetings in Washington on February 10-11. This would increase total IMF resources from $66.5 billion to $98.5 billion. The U.S. portion of the increase would be approximately $5.8 billion.
- an expansion and enlargement of the General Arrangments to Borrow which has been in place since 1961. Under the new arrangement, the GAB would be used when very serious balance of payments financing needs threaten the system, and IMF resources are inadequate to deal with them. It would be available to all member countries. GAB resources would be increased from $7 billion to $18.5 billion. The U.S. share of 25 percent, or $4.25 billion, would require about $2.6 billion in new funding.

The Impact of IMF Commitments on the U.S. Budget

U.S. participation in the IMF and the GAB requires Congressional appropriations, but does not result in net budget outlays or increased budget deficits. These are standby and reciprocal commitments. The entire amount of the U.S. quotas consists of a "line of credit" to the IMF. Dollars flow from the United States to the IMF only when needed. As the line of credit is used, the IMF simultaneously increases the United States' reserve position in the IMF by the same amount -- thereby offsetting the dollar expenditure on the U.S. budget. Called a "monetary reserve asset," it is a fully liquid interest-earning asset which the United States can exchange, without penalties or conditions, for currency to use for balance of payments purposes.

It must be recognized that U.S. contributions to the IMF do have an economic cost. At the time that dollars are drawn upon by the IMF, the U.S. government must borrow to raise the monies, thus increasing the U.S. government's borrowing requirements and thereby adding pressure on the capital markets. The IMF turns to the government only when there is a net increase in its need for dollars, after taking into account repayments in U.S. dollars to the Fund made by debtor countries. Thus, the calls on the United States for dollars have normally come in small increments relative to the scale of the government's borrowing programs.

The IMF and U.S. Interests

The IMF serves U.S interests in several ways.
1) The IMF provides resources to countries in support of their efforts to implement sound economic adjustment programs. Healthy markets overseas mean opportunities for sales of U.S. goods and services. This, in turn, supports jobs and investment at home. This is an important consideration that is not always fully appreciated. For example:

- over 20 percent of all industrial goods produced in the United States is exported;
- 40 percent of our agricultural production goes overseas;
- trade as a portion of GNP has more than doubled over the past 10 years.

The developing world is a critical part of this picture. More than 40 percent of exports of U.S. goods and services and one in 20 manufacturing jobs depend on sales to developing countries.

Weak economic performance in these countries has a direct impact on the United States. We have seen already an effect on U.S. trade with those developing countries facing major liquidity problems. For example, the value of U.S. exports to Mexico in 1982 fell 53 percent from the same period a year ago, declining from $17.8 billion to $11.8 billion. The value of U.S. exports to Argentina declined 70 percent; to Brazil, 11 percent. This point is important. The $6 billion drop in U.S. exports to Mexico is $6 billion in lost business that is very real to the companies involved and to their workers whose jobs may have been affected. Therefore, the United States has a strong and practical interest in helping our trading partners in times of economic difficulty to adjust and recover. To the extent the IMF is able to encourage these countries to take the necessary economic measures to restore their liquidity and creditworthiness, these countries will have a better chance to turn their economies around and revive demand for U.S. exports. Without IMF assistance in these difficulties their chances would be much dimmer and U.S. exports could fall even farther.

Some critics claim that IMF programs force excessive austerity measures on borrowing countries, slowing their growth and aggravating the global recession. It is also argued that, by calling for export promotion measures and urging countries to adopt policies that have the effect of curtailing their imports, IMF prescriptions take away jobs from U.S. export industries.

These arguments, I believe, are somewhat misleading. First of all, as a general observation, the objective of any IMF economic adjustment program is to help countries operate as close to normal as is possible and to avoid serious disruptions in trade and capital flows. In the negotiation of an IMF program, officials of the country, together with the IMF, determine what measures can be taken over a one to three year period to make the necessary adjustments. Essential imports, particularly those that sustain or add to the country's productive capacity, are protected to the fullest extent possible.

Secondly, and more important, the question is not whether imports may be reduced somewhat as the result of an IMF program; the question is how drastically imports would be reduced in the absence of an IMF program. Given the state of the economies of some of these countries, it seems clear that without an IMF program, their ability to import would be severely impaired, at best. If the objective is to try to maintain import levels as close to normal as is feasible, an IMF program is the best option available.

2) The United States, exercises strong leverage within the IMF. The United States as a major shareholder, holds 19 percent of the votes (controlling interest on major policy decisions is 15 percent). Thus, the United States has a leverage of approximately 5:1 in the IMF.

On top of this, the leverage the IMF itself exerts is considerable. The cases of Brazil and Mexico provide good examples. Brazil has agreed to undertake a number of policy changes in order to qualify for IMF financing.

The $1.5 billion of IMF funds committed to Brazil in 1983 holds together a total financing package in excess of $26.0 billion including $4.4 billion in net new medium-term commercial lending. The Mexico case is similar. IMF funds committed in 1983 serve as a catalyst for a total financing package in excess of $29 billion, of which approximately $4.85 billion is to be provided by commercial banks.

3) The IMF has proved itself to be an effective instrumentality. Over the years, the IMF's record of performance, in terms of achieving the objectives of its mandate, has been very good. Those objectives, of course, reflect the policy of the United States as a controlling shareholder in the organization. What is sometimes overlooked is the fact that the IMF is not an aid agency. In effect, it lends money; it does not make grants. And it does so, as mentioned previously, within the context of a program of conditionality that is designed to ensure that the funds provided are paid back. Specifically, when a country's currency is drawn by other members, a reserve position in the IMF results for the creditor country. This may be drawn upon by the creditor country at any time. IMF resources are not used only by developing countries. Many industrial countries, including France, Britain and the United States (most recently in 1978 for the amount of $6.5 billion) have used the IMF to meet short-term balance of payments needs. The IMF must maintain a certain margin of reserves against the possibility of such drawings.

In addition, the lines of credit it extends for one to three year periods are fully covered by resources it earmarks at the time. Operating expenses of the IMF are paid entirely from the interest, or "charges," on the use of IMF resources. All resources provided by the IMF have been repaid; there has never been a default.

Role of Commercial Banks

I would like to address briefly a common misconception that supporting the IMF is nothing more than a "bailout for commercial banks."

Far from bailing out the banks, the IMF has taken on the role of ensuring that commercial banks retain their commitments. In recent cases, the IMF, as a condition to proceeding with its own programs, has insisted that commercial bank lenders not only stay with their outstanding loans, but even increase them. Under present economic conditions, countries in balance of payments difficulties need to buy time to allow their adjustment programs to work. In many cases, the IMF has been instrumental in fitting together the pieces of a financing package sufficient to avoid default and to enable the country involved to work out an adjustment program. As you know, IMF programs have been undertaken in Turkey, Argentina, Brazil, Chile, Hungary, Mexico, Romania, and Yugoslavia, all important debtor countries. The result has been to minimize damage to the international credit system and allow the debtor countries to negotiate realistic payments schedules with their private and official creditors, while reordering their domestic economies to reduce future needs for external borrowing.

The commerical banks are very much involved in this process, and their continued involvement is essential to the success of the programs. In the long run, if the programs are successful, no doubt the commercial banks will benefit -- but so will the borrowing country, the international financial system, and U.S. industry, agriculture and labor.

Conclusion

It is unfortunate that this question of an increase in the IMF's resources, requiring an additional financial commitment by the United States, should come at this time of constraint and hardship in our own economy. However, circumstances -- mainly the current world-wide recession -- have led us to this point, and we have a problem that we must resolve. It must be resolved because it has a direct impact on the U.S. economy as well as the more general U.S. interest in maintaining a stable international economic system. The IMF in many ways is a unique instrumentality, well designed to cope with problems of this kind, and offers one of the most cost-effective ways for the United States to achieve our own national objectives on the resolution of that problem. We do not have many options available; to do nothing in these circumstances would have serious adverse consequences for the free world economic system, our general political and security goals, and, in a direct way, on the United States' economy itself. Our own economy cannot afford the risk of a major threat to the stability of the international financial system, or of a breakdown in international trade and capital flows.

For these reasons, the U.S. Chamber supports the proposals under consideration for strengthening the resources and role of the IMF as one of the best options available to deal with this problem. It may not solve the problem entirely; but if we do not take this step forward, there is not doubt that the problem will compound itself, and indeed become unmanagable.

STATEMENT FOR THE RECORD
on
THE INTERNATIONAL MONETARY FUND
before the
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
of the
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
by
Frank E. Briber, Jr.
Vice President
Allis-Chalmers Corporation
February 15, 1983

I am pleased to have the opportunity to present this statement on behalf of Allis-Chalmers, a heavy machinery and capital goods company which has been doing business in the international marketplace for well over 100 years.

The developing countries have an important place in our scope of business. Over a five year period, such countries have accounted for more than 50 percent of the Company's total U.S. exports. Furthermore, they hold great significance for us during the years ahead because of their infrastructure needs. A stable financial environment for these countries is vital to future success in this regard.

Therefore, I would like to bring to your attention an IMF success story from the perspective of a U.S. exporter. To us, it is a microcosm of the even bigger picture.

In the mid-1970's, the economic situation in Peru was such that a major copper project - Cerro Verde II -- was shelved. Then, in 1977, the IMF granted standby credits in return for austerity policies. Debt rescheduling was negotiated in 1978. Subsequently, improvements took place in the economy, although the worldwide recession has forced Peru to seek additional IMF assistance. Thanks to the IMF, the Cerro Verde project was reactivated in 1981, and U.S. exporters, including Allis-Chalmers, now are in the process of bidding on equipment having potential total value of up to $40 million.

Elsewhere in our hemisphere, the deepening financial crisis in Mexico is a major concern to all of us -- not only to suppliers. Even before the December 20 devaluation, it was found that 38 percent of the materials vital to keeping Mexico's industrial plants functioning had to be purchased abroad. The sum total in late October was a whopping $1.2 billion monthly, or $14 billion per year. In mid-January, Mexico's industrial plants were working at only 40 percent of capacity and unemployment had reached 50 percent in nearly 300,000 factories due to the shortage of machinery, spare parts and raw materials -- plus a near total lack of dollars to buy them with. Quite obviously, Mexico needs U.S. imports. In fact, approximately two-thirds of Mexico's imports are sourced from the U.S., and the IMF provides the underpinning for the financial resources necessary to support such purchases.

In summary, examples like those that I cited have convinced us that -- beyond the benefits to developing countries -- an expanded IMF base is an indispensable asset to the general economic health of the United States because of the employment and balance of payments impact generated by exporters.

Senator HEINZ. Thank you, gentlemen.

Mr. McDonough?

STATEMENT OF WILLIAM J. McDONOUGH, EXECUTIVE VICE PRESIDENT, FIRST NATIONAL BANK OF CHICAGO

Mr. McDONOUGH. Mr. Chairman, my name is William McDonough. I'm executive vice president and chief financial officer of the First National Bank of Chicago.

I'm also a cofounder and an interim director of the recently formed Institute of International Finance.

Additionally, I serve as a trustee of the National Planning Association and as the chairman of a subcommittee that is examining the problem of structural unemployment in the U.S. economy.

I believe there are two essential reasons why you should support the proposed expansion in the resources of the International Monetary Fund. One of these reasons is that it will benefit the U.S. financial markets and should lower domestic interest rates.

Our financial markets are fully interlocked with those throughout the rest of the world. Borrowers and lenders in this country and abroad move freely across national boundaries, and they arbitrage comprehensively among all of the markets that make up the world financial system.

Anything that affects a part of the system has a direct influence on rates in our markets.

FINANCIAL MARKETS FILLED WITH FEARS

Today, the financial markets are filled with fears. One in particular has certainly received the most attention by the media: the fear that the world financial system may collapse.

I do not believe the system will collapse. I believe the system will continue to function, whether or not you adopt this proposal.

But the risk of collapse exists; it is recognized—although in my view, exaggerated—in the markets; and the risk is considered to be higher now than in the past.

The market axiom applies: higher risks mean higher rates.

Risks are, of course, an integral part of any lending and investing activity. Lenders and investors are accustomed to assuming risks and recognize that the danger of some losses is inherent in committing funds.

Even though every banker, when he's making a loan, whether it's country credit or to the neighborhood hardware store, tries to assure that that loan will be fully collectible, all eventualities cannot be foreseen.

But these risks are credit risks, associated with the economic viability of the borrowers.

There is another risk in financial markets today; that is, systemic risk—the possibility that the entire structure of the world financial marketplace, in which borrowers and lenders together must transact business, will fall into disarray.

You have an opportunity through this proposal to allay the fears about this systemic risk. The precise role of the IMF in the international financial system is to insure that the system functions effectively.

The IMF was created after World War II in recognition of the interdependence of world financial markets, just as the Federal Reserve was created in 1913 in recognition of the interdependence of domestic financial markets.

The responsibility of the Fund, like the responsibility of the FED, is to facilitate transactions between borrowers and lenders in an orderly marketplace.

The IMF performs its role, in part, by extending credit. The proposal you are now considering would increase the amount of credit the Fund can extend.

But the IMF is not, and should never become a primary lender. At the end of 1982, by our estimates, which include all less developed countries, not just the nonoil ones, total foreign debt was around $720 billion; of that total, commercial bank loans were about $450 billion. All IMF loans outstanding were some $20 billion.

The IMF has consistently used its credit facilities to avoid the development of crises that could destabilize the international financial system.

The IMF makes conditional loans that require the debtor countries to take actions that will reduce the threat of disrupting the system.

The IMF has not, and indeed, cannot, insure that lenders will not take losses arising from rescheduling of interest and principal repayments.

With the growth in the world economy, the IMF now needs more credit in order to perform its limited but critical role of ensuring the continuing viability of the system. Every participant in the world financial marketplace knows that the IMF needs more credit.

They also know that the United States has traditionally held a leadership position in world financial markets. The question now being asked in those markets is: will the United States continue to be a leader?

The fear in the markets is that the IMF, absent U.S. leadership, will not have sufficient credit to avert what is seen as a potential crisis to the system.

If you approve the proposed increase in U.S. support for the Fund, it will reaffirm our Nation's commitment to the world financial system, thereby encouraging other countries to increase their allocations to the IMF.

That support will enable the Fund to perform its role, will allay the fears so prevalent in financial markets, and in my judgment will reduce interest rates in our domestic markets.

Lower interest rates always stimulate some increases in demands, whether from homeowners, consumers, or businesses. In the present state of our economy, perhaps in the embryonic stage of recovery, a drop in rates should flow through in substantial amounts to increased demands and to increased employment.

Certainly, every day in the Midwest, we see potential borrowers who are deterred by the present level of rates. And particularly, by the present level of real interest rates. The investment hurdles are simply too high.

The second essential reason why I believe you should support the proposal involves direct effects on the U.S. economy, in contrast to the indirect effects through lower interest rates.

Every U.S. company that exports or imports depends on stability in the world financial marketplace. U.S. trade requires reliable finance facilities. The international financial system has developed primarily to serve the needs of trade.

Let me talk about the Midwest for a moment, Mr. Chairman.

IMPORTANCE OF MIDWEST AGRICULTURAL TRADE

We in the Midwest know intimately the importance of trade. Every farmer recognizes its significance. Our Nation has moved from chronic deficits in agricultural trade in the 1950's to a position as a major agricultural exporter.

By 1971, agricultural exports totaled $7.7 billion, and created a national surplus in agricultural trade of almost $2 billion.

In 1980, the value of exports had surged to over $41 billion, and the national surplus was nearly $24 million. For the eight Midwestern States, exports as a percent of cash receipts from farm marketings rose from 16 percent in 1971 to 30 percent in 1979.

The Midwest is vitally concerned with nonagricultural trade as well. Of the 50 major exporting companies in the U.S. in 1980, 18 were in the Midwest.

The eight Midwestern States account for nearly one-third of all U.S. export related manufacturing shipments, and about 14 percent of the manufacturing employment in these States is in industries related to exports.

I have already indicated how the IMF facilitates world trade by stabilizing international financial markets through the use of its credit.

The IMF also performs a broader function that affects world trade directly: it has the primary responsibility for imposing economic discipline on countries that would have adopted policies incompatible with growth of the world economy.

Far more than any other international agency, the IMF has the role of encouraging sound economic policy in both creditor and debtor countries.

To the extent that appropriate economic policies lead to real growth in these countries, the world marketplace for goods and services expands.

IMF SURVEILLANCE AUTHORITY

The IMF implements its discipline both through its conditional lending and through the Fund's so-called surveillance authority.

Each of these is an important lever influencing countries in economic disequilibrium to adjust. The IMF smooths transitions during periods of economic change, as demonstrated during 1976–77 in the wake of the first oil shock.

At that time, several large countries—including Mexico, Italy, and the United Kingdom—were under severe financial pressure and turned to the IMF for support and guidance.

Each country adopted, and at least began to implement, an economic stabilization program that contributed to various degrees of economic recovery.

In each case, IMF financial support and consultation were crucial in containing economic deterioration.

In 1982 and 1983, the Fund is playing an even more key role. At present—in Mexico, Brazil, and Argentina, to name only three—the IMF is encouraging economic restructuring aimed at establishing the base for future growth.

The IMF is providing medium-term financial assistance and is coordinating the efforts of other creditors, particularly including the commercial banks, in the financial restructuring essential to recovery.

The Fund has been crucial in containing country debt crises and in beginning the process of reconstruction.

So the other reason why I believe you should support this proposal is because it will strengthen the ability of the IMF to perform its role in promoting world economic growth.

Such growth enhances the markets for U.S.-produced goods and services, both by increasing demand and by improving the financial health of our foreign customers.

In sum, I believe the expansion in the resources of the IMF can be supported on the basis of its domestic economic consequences.

Adoption will remove a significant impediment to lower interest rates, and lower rates will promote economic recovery.

Adoption will reduce some impediments that currently deter sound economic growth abroad, and the U.S. economy benefits whenever the growth potential in world markets is enhanced.

Thank you.

[The complete statement follows:]

STATEMENT BY

WILLIAM J. MCDONOUGH

EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

THE FIRST NATIONAL BANK OF CHICAGO

William J. McDonough. I am an Executive Vice President and the Chief Financial Officer of The First National Bank Chicago. I am also a co-founder and an interim director of the recently formed Institute of International Finance. Additionally, I serve as a trustee of the National Planning Association and as the chairman of a subcommittee that is examining the problem of structural unemployment in the U. S. economy.

I believe there are two essential reasons why you should support the proposed expansion in the resources of the International Monetary Fund. One of these reasons is that it will benefit U. S. financial markets and should lower domestic interest rates. Our financial markets are fully interlocked with those throughout the rest of the world. Borrowers and lenders in this country and abroad move freely across national boundaries, and they arbitrage comprehensively among all of the markets that make up the world financial system. Anything that affects a part of the system has a direct influence on rates in our markets.

Today, the financial markets are filled with fears. One in particular has certainly received the most attention by the media: the fear that the world financial system may collapse. I do not believe the system will collapse. I believe the system will continue to function, whether or not you adopt this proposal. But the risk of collapse exists; it is recognized - although in my view exaggerated - in the markets; and the risk is considered to be higher now than in the past. The market axiom applies: higher risks mean higher rates.

Risks are, of course, an integral part of any lending and investing activity. Lenders and investors are accustomed to assuming risks and recognize that the danger of some losses is inherent in committing funds. Even though every banker tries to assure that when each loan is made, it will be fully collectible, all eventualities cannot be foreseen. But these risks are credit risks, associated with the economic viability of the borrowers.

There is another risk in financial markets today; that is, systemic risk--the possibility that the entire structure of the world financial marketplace, in which borrowers and lenders together must transact business, will fall into disarray.

You have an opportunity through this proposal to allay the fears about this systemic risk. The precise role of the IMF in the international financial system is to ensure that the system functions effectively. The IMF was created after World War II in recognition of the interdependence of world financial markets - just as the Federal Reserve was created in 1913 in recognition of the interdependence of domestic financial markets. The responsibility of the IMF, like the responsibility of the Fed, is to facilitate transactions between borrowers and lenders in an orderly marketplace.

The IMF performs its role, in part, by extending credit. The proposal you are now considering would increase the amount of credit the IMF can extend. But the IMF is not, and should never become, a primary lender. At the end of 1982, by our estimates, total foreign debt of developing countries was around $720 billion; of that total, commercial bank loans were about $450 billion. All IMF loans outstanding were some $20 billion.

The IMF has consistently used its credit facilities to avoid the development of crises that could destabilize the international financial system. The IMF makes conditional loans that require the debtor countries to take actions that will reduce the threat of disrupting the system. The IMF has not, indeed cannot, ensure that lenders will not take losses arising from rescheduling of interest and principal repayments.

With the growth in the world economy, the IMF now needs more credit in order to perform its limited but critical role of ensuring the continuing viability of the system. Every participant in the world financial marketplace knows that the IMF needs more credit. They also know that the U. S. has traditionally held a leadership position in world financial markets. The question now being asked in those markets is: will the U. S. continue to be a leader? The fear in the markets is that the IMF, absent U. S. leadership, will not have sufficient credit to avert what is seen as a potential crisis to the system.

If you approve the proposed increase in U. S. support for the IMF, it will reaffirm our nation's commitment to the world financial system, thereby encouraging other countries to increase their allocations to the IMF. That support will enable the IMF to perform its role, will allay the fears so prevalent in financial markets, and in my judgment will reduce interest rates in our domestic markets. Lower interest rates always stimulate some increases in demands, whether from homeowners, consumers, or businesses. In the present state of our economy, perhaps in the embryonic stage of recovery, a drop in rates should flow through in substantial amounts to increased demands and to increased employment. Certainly, every day in the Midwest we see potential borrowers who are deterred by the present level of rates.

The second essential reason why I believe you should support the proposal involves direct effects on the U. S. economy, in contrast to the indirect effects through lower interest rates. Every U. S. company that exports or imports depends on stability in the world financial marketplace. U. S. trade requires reliable finance facilities. The international financial system has developed primarily to serve the needs of trade.

We in the Midwest know intimately the importance of trade. Every farmer recognizes its significance. Our nation has moved from chronic deficits in agricultural trade in the

1950s to a position as a major agricultural exporter. By 1971, agricultural exports totaled $7.7 billion and created a national surplus in agricultural trade of almost $2 billion. In 1980, the value of exports had surged to over $41 billion and the national surplus was nearly $24 billion. For the eight Midwestern states of Illinois, Wisconsin, Indiana, Iowa, Michigan, Minnesota, Missouri, and Ohio, exports as a percent of cash receipts from farm marketings rose from 16% in 1971 to 30% in 1979.

The Midwest is vitally concerned with nonagricultural trade as well. Of the 50 major exporting companies in the U. S. in 1980, 18 were in the Midwest. The eight Midwestern states account for nearly one third of all U. S. export-related manufacturing shipments, and about 14% of the manufacturing employment in these states is in industries related to exports.

I have already indicated how the IMF facilitates world trade by stabilizing international financial markets through the use of its credit. The IMF also performs a broader function that affects world trade directly: it has the primary responsibility for imposing economic discipline on countries that have adopted policies incompatible with growth of the world economy. Far more than any other international agency, the IMF has the role of encouraging sound economic policy in both creditor and debtor countries. To the extent that appropriate economic policies lead to real growth in these countries, the world marketplace for goods and services expands.

The IMF implements its discipline both through its conditional lending and through the Fund's so called "surveillance authority." Each of these is an important lever influencing countries in economic disequilibrium to adjust. The IMF smooths transitions during periods of economic change, as demonstrated during 1976-77 in the wake of the first oil shock. At that time, several large countries--including Mexico, Italy and the U. K.--were under severe financial pressure and turned to the IMF for supportand guidance. Each country adopted, and at least began to implement, an economic stabilization program that contributed to various degrees of economic recovery. In each case, IMF financial support and consultation were crucial in containing economic deterioration.

In 1982 and 1983, the Fund is playing an even more key role. At present--in Mexico, Brazil and Argentina--the IMF is encouraging economic restructuring aimed at establishing the base for future growth. The IMF is providing medium-term financial assistance and is coordinating the efforts of other creditors, including the commercial banks, in the financial restructuring essential to recovery. The Fund has been crucial in containing country debt crises and in beginning the process of reconstruction.

So the other reason why I believe you should support this proposal is because it will strengthen the ability of the IMF to perform its role in promoting world economic growth. Such growth enhances the markets for U. S.-produced goods and services, both by increasing demand and by improving the financial health of our foreign customers.

In sum, I believe the expansion in the resources of the IMF can be supported on the basis of its domestic economic consequences. Adoption will remove a significant impediment to lower interest rates, and lower rates will promote economic recovery. Adoption will reduce some impediments that currently deter sound economic growth abroad, and the U. S. economy benefits whenever the growth potential in world markets is enhanced. Thank you.

Senator HEINZ. Thank you, Mr. McDonough.

Mr. Clark?

STATEMENT OF GEORGE J. CLARK, EXECUTIVE VICE PRESIDENT, CITIBANK, NEW YORK, N. Y.

Mr. CLARK. Chairman Heinz, I prepared a rather extensive written statement, but instead of reading it,

I thought I might perhaps better serve by responding to some things that have happened in the room since we started this morning.

Senator HEINZ. Very well, without objection, we'll make your statement part of the record.

Mr. CLARK. Thank you, sir.

This may be a little less organized, but perhaps it will be more relevant, and it certainly will be more brief.

I thought I would respond by starting out where we, in fact, did start out, when you, with your opening comments, where you raised the very relevant question, I think, of how we can avoid the likelihood of a resurgence of the problems that we ccurrently face in this area.

PROPOSALS TO AVOID RESURGENCE OF CURRENT PROBLEMS

I have four specific proposals to try to respond to the concern that I think a lot of people have that we shouldn't just do this all over again.

I believe that the banks—I know Citibank is prepared to provide additional disclosure on our activities in the area of LDC lending, and we are prepared to publish quite specifically our outstanding exposure in the major countries, whereas in the past this exposure throughout the industry has been presented by grouping countries together.

We think that this may provide a useful purpose in making the public more generally aware of the situation, at least of our bank, with regard to this kind of lending by country.

We are also prepared to step up our reporting to the regulatory authorities. We are very receptive to proposals that your committee or regulatory agencies might make about providing additional details more periodically, and we are also prepared to discuss speeding up the process, so that we can have a more rapid and detailed and accurate data base.

Mr. McDonough mentioned the creation of the Institute for International Finance. We would be prepared to process our data through the U.S. regulatory agencies and on to the Institute, so perhaps we can develop a global statistical base of this nature that would be hopefully more timely and useful, and it might include some aspects of an early warning system, with very much in mind your point about avoiding a resurgence of this problem in the future.

Another point that they are acceptable to, and this was proposed earlier, is a change in the accounting rules, so that the fees for arranging our syndicated lines are recognized in our earnings only over the total period of the loan rather than at the beginning.

A fourth point that has come up this morning, and I added it to my list on the basis of what I heard here, would be efforts to stretch out the length of the loans that we make to these developing countries. I think that's an entirely reasonable proposal, and I think it's consistent with where we are in the global situation, the economy and the ability of these developing countries to service this indebtedness.

So there are four specific proposals that I hope would be helpful in avoiding a resurgence of the problem we face today.

I do want to take the occasion, though, to express two strong concerns I have about some of the other proposals that have been made today, and I think would have been really quite counterproductive.

ESTABLISHING LARGE RESERVES UNNECESSARY

The first proposal that really worries me is the suggestion that the commercial banks would be asked to establish large reserves against our sovereign risk loans in specific countries. I think this is a disconcerting proposal for many reasons.

In the first place, the past 50 years since the 1930's, commercial banks have collected just about 100 percent of the loans that we have made in this area. We have to go back a long way, half a century to find any significant failure to collect on these loans.

Now this record is in contrast to our corporate and individual clients, whereas we all know we typically do write off loans with corporate and individual borrowers, bank claims are extinguished and credit writeoffs do take place as a normal process; however, there is no comparable event in the event of sovereign lender. Even if governments choose to ignore creditors for decades, or even if governments declare unilaterally that they will not pay creditors' claims, those claims continue to exist and creditors present them periodically for repayment.

Governments do have the power to pay their debts currently or not to pay their debts currently, but governments cannot prevent legitimate creditors from presenting their claims for payment. In fact, the record shows that over the years governments do recognize these claims and do make payment, although in some cases with considerable delays.

Now in this situation, with this perspective in mind, the establishment of reserves for sovereign loans would be to apply a process that is well-developed for corporate and consumer lending, but which basically does not apply for sovereign risk lenders. In corporate or consumer lending, it is possible to develop techniques, actuarial studies and the like, to suggest a reasonable level of reserves against delinquent loans outstanding. This, in fact, is standard operating procedure for banks.

However, there are no such norms for sovereign lenders. The only norm that I can think of for sovereign lender is that the record bears out that governments do pay their international debts. Given that governments do pay their debts, how shall we set up criteria for hypothetical governments which do not pay their debts? What standards would be applied by regulators in such a situation?

It is this uncertainty which concerns banks. We are not in a position to know when we're making a sovereign loan, what reserves may be applied at a later date. We don't know what the criteria are. There is no basis for developing criteria. And I think that this uncertainty is so important to us as an industry that we may be driven to reduce our activity, and our role in the financial markets would be reduced at a time when governments are trying to stimulate global economic activity, if we persist in this proposal to establish large reserves for sovereign lending.

I think it goes without saying that because of this kind of record, I don't see the need.

The other point I wanted to make, in the testimony today with these repeated references to low-interest rates, I think that the consensus is that it's terribly important for the commercial banks to continue to help in the adjustment process. We certainly don't need to increase our loans as rapidly as we have in the past, but the deficits continue, and if we are faced with making new loans at low-interest rates—and Mr. Chairman, you wisely anticipated earlier that we would be saying this—I think we would be driven again, for this reason, from the field of activity precisely at a time when it's probably more important than ever for commercial banks to continue, albeit at a reduced rate to make these sovereign loans.

Thank you, Mr. Chairman.

[Complete statement follows:]

Statement by
George J. Clark
Executive Vice President - Citibank, N.A.

Chairman Heinz and distinguished members of this Subcommittee, my name is George J. Clark and I am an Executive Vice President of Citibank, N.A. I appreciate the opportunity to discuss with you my views on the current international financial situation.

It is axiomatic that finding a correct solution first requires proper definition of the problem. Unfortunately, there is still a great deal of confusion as to just what kind of a problem we face. Some say its a banking problem, others say its a world economic problem; some say it's an LDC liquidity problem, others say it's an LDC solvency problem.

The primary problem is that we face serious world economic recession which is affecting the banks along with everyone else. The banks' difficulties are highly visible symptoms of this far larger problem but they are not the totality, let alone the cause, of the real problem.

Our basic view is that the international financial system performed reasonably well in the period between the first and second oil shocks - roughly 1973 to 1979. The banks successfully recycled the OPEC surplus, benefiting everyone -- domestic employment rose, LDC living standards rose and the banks profited. Then, because of the second oil shock and other unforeseeable events, the current world economic problems developed. We view these problems to be difficult but manageable given good public and private sector leadership here and abroad.

To put current problems, as well as legislative proposals, in perspective, this testimony will briefly review the period to the end of the decade of the 1970's and then cover the 1980-82 recession. Finally, it will address the outlook for recovery and, in that context, the proposed increase in the IMF quotas as well as some of the other solutions currently under consideration here in Congress.

The genesis of our current problem traces to the first oil shock in 1973 when the world was confronted with an unprecedented transfer of wealth to the OPEC countries and the need to recycle this. At the same time, the major industrial nations went into a severe recession. The international system survived these combined blows. By 1977, the OPEC surplus was declining, and the industrial countries were recovering from two years of recession. By 1978, the OPEC surplus had disappeared. Real growth in industrial countries continued at about 4% through 1979. LDC current account deficits dropped from 31% of exports in 1975 to 13% in 1977. Although two years later they had climbed to 18%, this was still no more than the average 1967-72 ratio.

Several years of large LDC current account deficits saw a number of debt ratios deteriorate by 1978-9 as compared to 1973. Reserves to imports were on the low side; the level of debt, in relation to exports and GNP, was somewhat high, as was debt service to imports. But since the OPEC surplusses had disappeared and LDC current deficits appeared under control, it seemed a matter of gradually working the ratios back to normal. Indeed, the ratios generally did improve through 1980.

The banks had stepped in and recycled the OPEC surplus, helping the LDCs to continue to import while adjusting to the new situation. Bank exposure to LDCs through 1978 rose $15-25 billion each year. Objective observers generally agreed that recycling had been successfully handled. Not that there were no write-offs, reschedulings or mistakes. There always are.

At this juncture, let's illustrate what all of this bank lending meant to our domestic economy by giving just two examples of Citibank LDC loans. First, Citibank participated in the financing of four A-300 aircraft costing approximately $40 million each for Varig-Cruzeiro Airlines of Brazil. While these aircraft were manufactured by a European consortium, the engines - representing approximately 18% or $29 million of the total equipment cost - were manufactured by General Electric near Cincinatti, Ohio. A point here to be noted is the highly interrelated and economically interdependent world we live in -- a Brazilian airline buys European airplanes and creates jobs in Ohio, with the help of Citibank. Another example is Mexicana Airlines of Mexico. Citibank was lead bank for a syndicated financing of three Boeing

727-200 aircraft with an approximate total cost of $48 million. These aircraft were manufactured in Seattle and the engines representing 20%, or $9 million, were built in Middletown, Connecticut by Pratt and Whitney, a subsidiary of United Technologies.

Compare this last example with the recent headline in the New York Times, (2/5/83 at p. 33) announcing that Pratt and Whitney was laying off 2300 workers in Connecticut because of falling domestic and foreign demand. Those who criticize Citibank's loans to Mexico and Brazil might wish to compare notes with the unemployed workers in Seattle, Cincinatti and Middletown.

Turning to the next phase, new shocks hit the system in 1979 and thereafter. We were back on the roller coaster. Revolution and war in the Middle East caused a drop in OPEC capacity. The price of oil rose again and the OPEC surplus once again grew quickly. Another $200 billion was accumulated from mid-1979 through 1981.

In most of the major industrial countries, the fight against inflation began in earnest. Economic growth stagnated. Interest rates climbed to extraordinarily high levels and commodity prices, in real terms, dropped to historically low levels. Terms of trade for the developing countries fell for five straight years.

Reflecting these volatile forces, non-oil LDC current account deficits rose sharply yet again and the various debt-related ratios deteriorated. At the same time, bank lending, net of repayment, accelerated to $40-50 billion per year in 1979-81, up from the earlier $15-25 billion flow per year.

In the second half of 1982, three countries with fundamentally powerful economies found themselves in a severe liquidity bind. All three were grappling with hard financial problems at a time of internal political change and uncertainty. Their vulnerability was compounded by inappropriate adjustment policies (Mexico at the close of its presidential term), spillover effects in the credit market (Brazil's needs became difficult to meet in the wake of reaction to the Mexican crisis) and armed conflict (Argentina mobilized its resources for war in the South Atlantic).

The confluence of all these worldwide economic, financial, psychological and political developments, not subject to prediction even by sophisticated analysis in governments or banks, produced a situation requiring drastic and concerted action.

The response of the international community is known. Ad hoc but efficient arrangements were quickly made within the banking community. Governments and central banks stepped in to bridge gaps in financing. The International Monetary Fund and the Bank for International Settlements addressed the problems pursuant to their charters. The external pressures, of course, are not confined to the three large debtor nations mentioned above. The pressures bear on many countries and involve institutions, businesses and individuals, lenders and borrowers, and are rooted in the global slowdown in economic activity and trade.

We have not yet, by any measure, solved all of the problems confronting us. Nevertheless, the interacting public and private sectors, working through existing institutions and creating new ones (e.g. Institute of International Finance), have shown resiliency and steadfastness in the few months since the dimensions of the problem became clear.

For the future, it is manifest that the volume of lending to LDCs should not continue at the 1979-81 rates. The banks are already slowing down. Based on the most recent but partial statistics, the flow to LDCs was probably about $25 billion in 1982 compared to $50 million in 1981. It is also clear, on the other hand, that the banks should not overreact and actually cut back total exposure - that kind of reaction in the present circumstance would cause extreme liquidity difficulties and prolong the world recession. In fact, it is necessary that bank exposure continue to rise, but moderately. Roughly 7% has been the rate of increase used in the Mexico and Brazil programs. Correspondingly, the LDCs will have to reduce their current account deficits to more sustainable levels. But to require the debtor countries to reduce the deficits to zero or even to run surpluses (if overall debt levels were to be reduced) would cause dangerous and unnecessary political and economic dislocation.

What I have said thus far can be summarized as follows:

In recent years the developing world has been following overly expansionary monetary policies producing distortions which were reflected in large current account deficits. In a low inflation, low growth world these countries can no longer afford such expansionary policies. They need to speed up greatly the so-called adjustment process. This is precisely the role that the IMF was created to perform, so support for the IMF is very important.

To some extent these proposals are "tough" because they are disinflationary. For countries living beyond their means, a reduction in artificially high real incomes is inevitable. However, it has been our experience that well-conceived, comprehensive programs, worked out between debtor countries and the IMF, offer the best way to carry out these adjustments while setting the stage for sustainable growth in the medium term. Under such programs, the reduction in income in the short run is minimized and income in the long run is maximized by the more efficient allocation of resources. In my opinion, correcting the recent misallocation of resources could eventually save the developing countries as much as the $30-40 billion adjustment required in their balance of payments.

In case you feel I may be too optimistic about how quickly the adjustment can be accomplished, note the following. Mexico and Brazil have adopted programs which will generate current account deficits of $4 billion and $7 billion respectively for 1983. These are less than one-half of their combined 1981 deficits for a total saving of $12-14 billion. These two economies will accomplish roughly a third of the necessary $30-40 billion reduction in current account deficits.

Turning to the desired increase in International Monetary Fund quotas, this matter should be put into the proper perspective. In my judgment, the IMF quota increase is not intended as some sort of cure for a banking crisis. Indeed, to my knowledge, no banker has asked the Government for help.

Rather, the proposed increase is one step toward solving the world-wide economic problems which plague most nations. Today's economic stagnation, slowing of international trade, lower demand for our exports, and high rate of unemployment, were surely not caused by bank lending. As a matter of fact, had it not been for the recycling process, these problems might have hit us much earlier and with much more serious implications.

The IMF has played a significant role in the past and its effectiveness should be maintained if we hope to restore economic health to the global economy. The quota increase is significant to that effort. It appears a small price to pay to help the world move toward that goal.

Of course, if the increase is not approved, everyone concerned will simply have to adjust to that decision: the IMF would be forced to adjust; the banks can and will adjust to it; the developing countries, perhaps most particularly, will have to adjust to it. The distinguished members of this committee and their constituents will also have to adjust to such a decision - in lower demand abroad for U.S. exports, thus reducing job creation in your districts' manufacturing and farming sectors where unemployment would remain at higher than necessary levels. The IMF quota increase proposal will materially affect domestic jobs because of the growing numbers of our workers and farmers who depend on healthy foreign markets for their livelihood.

The last point about domestic jobs is so important I want to highlight it in another way. I've already mentioned Citibank examples of LDC loans that produced domestic jobs (see page 3). More generally, testimony to the House Banking Committee last week estimated that 4/5 of the new jobs created in the U.S. from 1977 through 1980 were associated with the strong growth of exports during that period. And perhaps a million domestic jobs have been lost due to the sharp deterioration in foreign trade during the past two years.

The IMF has become a key element in today's interdependent world. It is a source of important influence for stability and growth in that world. Its efficiency benefits all of us. Its inadequacy would hurt all of us. Let's provide this reasonable addition to IMF resources, which have not kept pace with inflation or real growth in world trade, and get on with the job of restoring the U.S. and the global economies to sensible, well-managed levels of growth.

Turning to some of the other "solutions" being mentioned in the press and here on Capital Hill, recent months have seen a number of well-intentioned suggestions to make major changes in the international financial system to protect the banks, help the LDCs, or both. These proposals are predicated on the notions that the current system has failed, and that radical surgery is necessary. I disagree with this hypothesis -- as I have mentioned, I think the system has worked quite well, and that the record shows this. Moreover, I think the current problem facing the international financial system can be successfully managed if there is good public and private sector leadership here and abroad.

Accordingly, I think there is no need seriously to consider the range of proposals calling for radical changes.

Going beyond this fatal flaw, the radical reform proposals cannot be defended on their own terms. For example, George Champion recently published an article entitled, "Foreign Debts: A Proposal For U.S. Banks" (The Wall Street Journal, January 11, 1983) which has attracted some attention. As I analyze his proposal, it had several main elements.

First, U.S. banks would be required to discontinue lending to Iron Curtain or developing countries except to fulfill existing commitments. The facts simply do not support this change; U.S. bank losses on international loans have been proportionately less than on domestic loans, and the latter have been well within reasonable limits. If the banks had not lent to developing countries in the past, who would have recycled the OPEC surpluses? Furthermore, it is my view that it is appropriate for the banks to lend funds to well conceived, capital projects in the developing countries. Funds from other sources have been and will continue to be inadequate. Because there are temporary liquidity difficulties does not mean that lending per se is bad. Because Chrysler gets in trouble, does that mean all bank lending to U.S. corporations is bad? By contrast, note that the U.S. in the 1800's borrowed extensively abroad to finance its own development; we are all the beneficiaries of those early LDC loans. Should we not give the LDC countries of today the same opportunity for betterment?

Second, the regulators would require U.S. banks to write down their non-performing loans by at least 50% of their face value, using up to half their pre-tax earnings for the next five years to accomplish this. This arbitrary approach does not make sense. In the first place, we think these are sound loans and there is no reason to write them down. Second, the arbitrary 50% or more write-off makes no sense even if the loans are not worth face value. The bank regulators, the SEC, and particularly the accounting profession have worked out sophisticated procedures as to how, when and to what extent a bank should write off a particular loan. No reason is given -- nor can I think of one -- why we should not continue to follow these proven procedures.

Moreover, U.S. banks, with LDC loans equal to or greater than their capital, would be discouraged from dividend increases and from acquiring new businesses which reduce capital ratios. Here, too, current procedures already take care of this problem. That is to say, banks with impaired earnings often reduce or eliminate their dividends -- we have seen recent examples of this. Moreover, the regulators already take into account capital ratios when considering applications for acquisitions.

Let me turn to another proposal currently receiving a lot of attention in the press. This one seems to trace its roots to an article by Felix Rohatyn, "The State of the Banks" (New York Review of Books, November 4, 1982). No legislation has been introduced, and the proposal as now discussed here on Capitol Hill seems to have many variations, and to lack specificity, thereby making analysis rather difficult.

However, the central idea seems to be that a new or existing government agency would exchange its own long-term, low-yielding bonds for the banks' LDC paper. This would protect the banks, at some yet undetermined cost to them, from possible LDC insolvency. Then, the agency in turn would convert the LDC debt taken from the banks into similar long-term, low-yielding obligations. This would reduce the LDC's burdens and, so goes the argument, enable them to get on the path to economic recovery by reducing debt service and increasing borrowing capacity.

None of us has yet seen a detailed proposal; however, based upon the published views of some advocates, I have strong reservations. The whole approach strikes me as wrong on several counts.

Most importantly, it is not the appropriate remedy for the liquidity problem the debtor countries face today. That remedy is to be found primarily in the adjustment process I have described earlier, with the IMF playing its important role. Of course, a general economic recovery in the industrialized economies would help, but adjustment without that recovery is possible and is the key remedy.

Next, this approach is not only unlikely to achieve its stated objectives, but risks actually harming the interests of those countries it is intended to assist. As bankers, we expect that the servicing of these loans - either on their original terms or in accordance with new terms and conditions worked out between lenders and borrowers - will be carried out. Any forced transfer of these assets under terms adverse to the banks' interest will surely be resisted not only by the lenders but also by the most important debtor nations. These nations may well fear that involvement in this kind of program, whatever its immediate short-term benefits, would endanger their creditworthiness and thus their future access to badly needed external capital. These fears would be well founded. There is little doubt that for government to impose such schemes on lenders would make banks less willing to lend to the countries involved for the foreseeable future.

We must keep in mind that the so-called Third World is composed of countries in greatly varying circumstances. Some, the weakest economies, have never developed access to external private capital and remain dependent upon official aid from governments and development banks -- at concessional terms. The most advanced of the Third World economies, however, -- and it is precisely these who are the major debtors to banks -- do attach (and must attach) a high value to their reputation in the marketplace: it is often a hard-won asset, and responsible leaders choose policies least likely to damage it.

I believe it is for this reason that we have heard no chorus of enthusiastic endorsements for Mr. Rohatyn's proposals from the major borrower countries. And, as a banker, I believe it would be understandable if these countries had serious misgivings. The resulting exclusion from private sources of external capital could seriously impede their future economic development. They know that official aid could not fill the gap.

One historical example will illustrate what I mean: During the late 1970's, the "Group of 77", purporting to speak for the LDCs as a whole, proposed a global debt moratorium. While the concept was enthusiastically endorsed by those poorest nations whose only debt was to governments (and to other official agencies -- such as the one which would be set up under these proposals), the stronger LDCs who had access to private capital immediately disassociated themselves from any such idea.

Beyond the proposal's impact on the borrowers and the commercial banks, it raises further important questions. There is no reason to expect that a new agency would be better able either to get the debtor countries to follow effective economic policies, or to collect on past loans. There appears, furthermore, to be no recognition of the fact that non-U.S. lenders are involved. Reaching a global consensus on this complex, far reaching idea is improbable. Can or should the U.S. Government attempt to address unilaterally issues affecting foreign as well as domestic banks?

Last, but far from least, we must consider the interests of the U.S. taxpayer. Is it really fair to ask for official U.S. funding of such an agency, given the uncertainties and the likely counter-productive impacts which I have outlined? Alternatively, if the U.S. is to assume management of the LDC loans but no obligation to repay them, and the banks are to be paid if and to the extent the loans are repaid, this raises serious Constitutional questions as well as questions of equity and fairness. On the last point, government management of these loans could also seriously conflict with the conduct of our foreign policy and, if political, not economic decisions prevail, collection of the debt would become a highly speculative matter.

I believe I have identified some serious questions about this whole approach which must be given careful consideration. And, in that sense, I hope that my remarks will have been helpful to you, Mr. Chairman, and to the distinguished members of this Committee. Thank you.

Senator HEINZ. Gentlemen, thank you very much.

You have made some extremely interesting statements. There are a lot of questions that I have for me. We are not going to have time to get into all of them.

A few quick questions on the testimony that I would like to make.

AMERICANS PAYING RISK PREMIUM FOR INTERNATIONAL DEBT

Mr. McDonough, you made what to my mind at first impression is a relatively extraordinary statement, which is, "If we just do this one piece of legislation, which I am in favor of, interest rates will be lower." And apart from the fact that I can't imagine the Congress doing anything to lower interest rates, short of a "putsch" to the Federal Reserve, which some members have in mind, but not me, it seems me that on its face that's a bit of overpromising, but even more importantly from a practical point of view, the only way that I could see where that would be true, is if today American borrowers are paying a risk premium to American banks for the excessive overextension of credit by American banks and others abroad.

Is that your contention that Americans are today paying a risk premium for overseas banking activities?

Mr. McDONOUGH. Mr. Chairman, I think one has to divide the interest rate that a bank charges into two components, the bank's overall cost of funds, since a bank is an intermediary, and therefore, borrows funds itself and lends them to its customers. The level of interest rates which is being charged now does not have a higher component, in my view, of interest margin caused because of the overall risk factor in the international economy.

Senator HEINZ. That's an extraordinary statement in itself. Real interest rates are about the highest they have ever been.

Mr. McDONOUGH. Yes; but I'm dividing in the component of the nominal interest rate between the bank's cost of funds and the margin——

Senator HEINZ. Let's talk about that portion of the interest rates between the richest rates you charge and the inflation rates. Why is it so high?

Mr. McDonough. I think the real interest rate in the economy, that is, the nominal interest rate that you see, less inflation, is extraordinarily high for a number of reasons.

Senator Heinz. And none of them relate to the international debt situation?

Mr. McDonough. No; the international debt situation is a portion of it.

Senator Heinz. Then we're paying a risk premium today. Americans are paying a risk premium today, because of the international debt situation. So that's my question.

Mr. McDonough. Yes.

Senator Heinz. I think the answer you gave is yes.

Mr. McDonough. Yes; but may I clarify the remarks?

Senator Heinz. Surely, but I've got a lot of questions, so keep your answers brief.

Mr. McDonough. It'll take a 30-second clarification. It is not translated into additional earnings for the banks.

The banks are charging what they see as normal rates; however, the real interest rate is high because of the international situation, among other things, and therefore, in that sense, your conclusion is something with which I agree.

Senator Heinz. Thank you.

Mr. Clark, I want to thank you for your suggestions on how we can avoid a reccurrence. They all look like helpful suggestions.

There are other alternatives, as you know, the committee will be considering.

Let me just clarify something you said about the establishment of sovereign risk limits for these debts— excuse me—for loan loss reserves against sovereign risk debts. As I understand the term "sovereign risk debts," you're talking about those loans to foreign governments. You are not talking about loans to businesses, although they might be foreign domiciled business in those countries. Is that a correct distinction?

Mr. Clark. It's a little complex. You have loans to governments which clearly are sovereign, but then you also have loans, the servicing of which may be delayed because the local borrower has paid the local currency, but the central bank hasn't remitted the foreign exchange, because it probably doesn't have the foreign exchange.

When I used the term "sovereign" I was thinking of both government and loans that might be backed up, in this sense by government.

Senator Heinz. Now we had some testimony from Mr. George Champion, who is not inexperienced in banking matters, who said we shouldn't lend to foreign governments at all, ever. What do you say to that?

Mr. Clark. Mr. Chairman——

Senator Heinz. His risk limit, at least for the government's portion, would be zero.

Mr. Clark. That's a philosophical point, and we have some very fine officers in Citibank who have a similar point of view. Obviously, most of us——

Senator Heinz. One of them should rise to the chairmanship of the bank.

Mr. CLARK. We would almost be out of business, because a great deal of U.S. and other commercial bank lending today around the world is to governments. So, I think as a matter of record and fact, most of us have left that kind of point of view behind, and we now do an awful lot of business with governments around the world.

Senator HEINZ. Because you want to be promoted at the Citibank? [Laughter.]

That's a low blow. I didn't mean it that way. It may have come out that way.

But let me get to the point of this line of inquiry. In saying there should not be any kind of change in the way loan loss reserves are accounted for here, are you also saying that there should be no limits, no sovereign risk limits?

Mr. CLARK. I was going to comment, Mr. Chairman, on the subject of sovereign risk limits, but I knew it was getting late in the day. In the first place, every bank today, I believe, has its own limit per country. An enormous effort is put into developing those limits. I know how it is at Citibank. It is one of the biggest things that we try to do. So, there are country limits already. The only question is who sets them. And the choice is whether to let the banks go ahead and set their own limits—and you know, I think that's what we ought to do. And I think that it would be very contrary to our whole spirit of division of public and private enterprise for the government to intervene in that.

Now there are others who obviously don't have that point of view. I would say this, though, that if the Congress and the regulatory authorities, in their wisdom, choose to go that way, they will obviously have our compliance.

BANKS IMPRUDENT IN THEIR LENDING

Senator HEINZ. Now there are those who would contend that the banks have been imprudent in their lending, and that case has been advanced not just by Mr. Champion, a banker himself, but by others. And I think what the lowest common denominator and probably fairest aspect of that criticism is, that a great deal of international lending has been to finance consumption in LDC countries and not to finance productive capability that would strengthen the economy of those countries.

How would you respond to that specific criticism?

Mr. Clark?

Mr. CLARK. Mr. Chairman, I think many of the people who say we have been irresponsible today, 2 years ago were pointing out that we had to perform this function because we had the very large deficits on the one hand and the surpluses on the other, and that there was a real threat that the international financial system would break down, if we didn't perform the intermediation process.

Senator HEINZ. There were also people, by the way, who would say we did too good a job recyling the petrodollars. And it's at the margin, if you will, between what was a necessary job and what was an overenthusiastic job, that the critics may have a point.

I'm sure you received all these petrodollars. You had to do something with them. You lent some of them overseas, and no one would question, I don't think, that some of them had to be lent overseas, but the question is, did we lend them as wisely as we should have, or did we just get into a feeding frenzy, where Citibank, which has 100 percent of its capital exposed in Brazil, if Citibank didn't make a loan, some other bank might. There was a profit opportunity foregone. How much of the latter was there?

Mr. CLARK. Well, Mr. Chairman, I think if we had known 2 years ago that we were going to have this slowdown in the global economy that we've had in terms of trade and in export prices in the developing world were going to be as poor as they were, we would have done less, but you know, we didn't know, and nobody else knew. And it's really very hard to point out at which point the burden did become too heavy.

Senator HEINZ. Well, let's return to the original thrust of the question, which is, namely, the use of the financing for consumption as opposed to more secure kinds of purposes, secure, specifically, from your point of view as bankers. You know, if an American businessman comes to you for a loan, the chances are, if he has—if you have any doubt whatsoever about his financial stability, you will take liens on capital assets, the inventory and anything you could get your hands on, if you have the least bit of doubt.

What's your answer?

Mr. CLARK. Mr. Chairman, I remember earlier there was a question put to Mr. Champion, wasn't it true the developing world has moved ahead very rapidly in the last 10 years, in the terms of GNP. That was a very wise perception.

We feel we financed most of that growth. It is terribly hard to break it down. Funds are fungible, but we feel that was a period of rapid economic growth and we were providing the capital that the domestic savings market could never have done precisely to help that growth take place.

Senator HEINZ. There's a lot of feeling that at the same time you were promoting that growth, the kind of domestic economic growth that we observably were having in terms of both real and nominal GNP in 1979 and 1980, was in fact will-o'-the-wisp economic growth, where once again consumption was emphasized to the exclusion of savings and investment.

Indeed, there is a fellow at your bank named Wriston, who has been making that speech for about the last 5 years.

Mr. CLARK. As distinct from consumption and investment, it is just very hard to know, Mr. Chairman.

I do think it is fair to say that by 1981, 1982, the adjustment process to the petroleum prices and low export prices hadn't gone far enough, and that is why we welcome now the speedup in the process. And that is why we support the Fund proposal, because they are in the best position to see that the adjustment process—which is another way of talking about consumption—does take place more rapidly.

Senator HEINZ. You also made the statement a minute ago that you could not have foreseen the recession that we are experiencing.

I don't understand that, I'll be very honest with you, when in 1973 the price of oil went up from $5 to $13, an $8 increase. The immediate result within a year, a year and a half, was a very deep recession, the recession of 1975-76. It was deep, it was reasonably quick as recessions go. But, it was quite steep, and there was no doubt in anybody's mind what caused it; it was the oil price shock of $8 of 1973.

So, in 1979, roughly, we saw run up of oil prices from $13 to $33—round dollars. Not $8, but $20, 2½ times that. And I honestly don't understand how someone could say, well, I never expected that to cause a recession.

It caused a recession in 1975. Why couldn't it be expected to cause a worse recession a year or two after 1979, as in 1981-82 and 1983 where we are. Just as somebody who understands logic.

Mr. CLARK. Well, one thing, when we voted for Mr. Reagan, we understood things were going to get going again. It was very much in that period.

It is also true that we thought we were going through the second oil shock the way we went through the first oil shock.

And by 1979 we pretty much were coming out of that one when we got hit with the second whammy. So, we thought it was a deja vu activity. In fact, we never did get out of it because we got that terrible slowdown in global economies in 1981-82. World trade actually dropped in 1981.

You have got to go back to about 1971, I think, before you find a year when world trade actually went down. You know, it just didn't appear to be in the cards.

Senator HEINZ. There wasn't any flattening of world trade in 1974-75?

Mr. CLARK. Well, of course, you would have to adjust for the oil.

Senator HEINZ. Yes.

Mr. McDonough?

Mr. McDONOUGH. If I could hazard an answer, Mr. Chairman, I think what happened, the difference between the two periods is this:

One could anticipate after the second oil shock there would be a recession and the recession took place. I believe what wasn't forecast—or at least what I didn't forecast—was that there would be a double-dip recession in which commodity prices would go very low and stay very low for an extended period. A recession in which in a number of the key countries—certainly the United States, the United Kingdom, Germany, and Japan—you had a very peculiar mix of fiscal and monetary policies; rather expansive fiscal policy and rather tight monetary policy, another contributor to these very high real interest rates.

So, from the viewpoint of developing countries, you literally had the worst of all worlds; you had very low commodity prices and in the case of Brazil, exports of manufactured goods fell radically because most of their customers are other developing countries—and very high interest rates, so the service of their debt was excruciatingly difficult for them.

It was a combination which, perhaps, one should have foreseen. I don't find even a good country lawyer who is prepared to tell me he had foreseen it.

LOANS TO ZAIRE AND POLAND

Senator HEINZ. One of the suggestions that has been made, and it occurred in a variety of forums, is that where countries—and I think that Zaire and Poland were mentioned—where there is a limited to nonexistent chance of ever getting the loans paid back, that there really should be a method of reflecting that in the earnings or reserves of banks.

Let's take the case of Zaire. Mr. McDonough, do you really believe it is going to come through for you?

Mr. CLARK. Mr. Chairman, it just is an absolute coincidence. A month ago I was in Kinchasa, and met with the President, Mr. Mobutu, and he said, "We owe you every penny of what you say we owe you. If copper gets back to 90 cents a pound, we will pay it all."

So, even he has that hope.

Senator HEINZ. Hope springs eternal.

What's the price of copper today?

Mr. CLARK. It is quite a way from 90 cents. But, it could get back there. [Laughter.]

Senator HEINZ. What did you say it was?

Mr. CLARK. About 75 cents now.

Senator HEINZ. Would you expect him to say anything different than he said to you?

Mr. CLARK. No, sir. It is just—it is a point I made earlier, an absolute recognition on the part of the government that it owes these obligations and it has to pay them. And that is important because they know that they don't have the domestic savings to make the investments that they need. They are terribly concerned about their credit standing, and the record bears this out. All you have to do is look at the record and you find that sooner or later these governments do, in fact, pay their obligation.

Senator HEINZ. I am going to submit a number of much more detailed, even statesmanlike questions for the record. [Laughter.]

We do want it to be a balanced interrogatory.

But one question that is going to recur, and you are, indeed, I think somewhat fortunate that this is taking place during the lunch hour.

Many of my colleagues, including myself, really want to know if any banker in America feels that any bank, including their own, in America, has been in the least bit imprudent in making any of these loans. My impression is that nobody at this table feels that anybody has been imprudent, or if they did, would not want to be caught on the record saying so.

But, since that is just an impression, you haven't said that, let me ask you: Do you think that American banks bear any responsibility for having gone a little too far here?

Who wants to go first? [Laughter.]

Mr. McDONOUGH. I'm not sure, Mr. Chairman, if the right word is "imprudent." Let's go back to——

Senator HEINZ. How about "excessive," or "overly enthusiastic"?

Mr. McDONOUGH. Let's decide when we are going to look at it. As of 1983, given the facts that I just mentioned, that I, at least, and my colleagues at my bank did not foresee a double-dip recession with very high interest rates, very low commodity prices, do we feel that the indebtedness of a number of LDC countries is so high as to be a problem for them to service?

The answer is, "Yes."

Since we have exposure to those countries, are we concerned about that exposure?

The answer is, "Yes."

What do we think is the best thing to do about it?

We think that in certainly the case in which a reasonable amount of hopefully noninflationary recovery of the world economy can take place, over a reasonable period of time these economies can recover to the point of returning their debt service to more tolerable levels. It is appropriate for us, for the banking system in general, for the IMF, to seek to bring about an orderly solution to the problem.

I think it is folly to pretend that a problem does not exist. We have a very weak world economy and a very high level of debt. The question is——

Senator HEINZ. Would we be having hearings on all this legislation if all this wasn't true?

Mr. McDONOUGH. That's right.

Now, do I think that banks in 1980—and there I must speak about my own bank only—do I think that we had procedures in place, do I think that we adequately studied countries, do I think that we did our homework thoroughly and made our judgments prudently?

Yes, I do.

Do I think that there was a piece missing which made it difficult, especially in 1981 and 1982 to follow what was going on well?

Yes, there was a piece of information missing. And that is the thing that many of us through the Institute of International Finance in the private sector are trying to improve. And that is that the flow of information from countries, particularly about their indebtedness, was too slow.

So, we knew what we were doing in our individual banks, but we didn't know quickly enough what was going on in the system as a whole. I think we would have seen some rockets going off earlier if we had a system that would have given us quicker information.

I know my friend Jack Clark suggested that is one of the things that he and his bank feel should be improved, and I certainly share that view. We can't operate without a much quicker flow of information, because we must know what is going on as quickly and as thoroughly as possible in order to make prudent judgments.

Senator HEINZ. Mr. Clark, what do you think? Do you think there has been any imprudence here?

Mr. CLARK. Mr. Chairman, I already mentioned that if we knew today—if we had known 2 years ago what we know today we wouldn't be where we are.

Now I don't know if that is imprudence, or lack of foresight. I actually do think—the one that got out of hand was Mexico, and I think what Mr. McDonough has just described was very much the case. Things were happening very rapidly. We all had our own analyses going, but we really didn't know what the industry as a whole was doing, and that does get back to the data base.

And as I indicated, we have to address that.

GROSS ABUSE OF THE FEDERAL FUNDS MARKET

Senator HEINZ. Let's get down to cases. Mr. Martin Mayer referred to what he considered to be a "gross abuse of the federal funds market" by the agencies and branches of foreign banks.

Those funds, apparently reached a high of as much as $445 billion one day last September. According to Mr. Mayer in 1981 and 1982, branches of Mexican and Brazilian banks used their access to this market to fund their nations' continuing and growing foreign exchange deficits. Apparently some $10 billion might have been involved in that at any one time.

This was done, he claimed, because the Mexicans and Brazilians were willing to pay another eighth.

It seems to me that what is involved is putting our nation's financial system in jeopardy for an eighth of a point. This overnight money was never meant by anybody responsible, as far as I can tell, to be used for balance of payments deficit financing.

So my question is this: Did that practice take place?

How did it develop?

Do you agree that it is an abuse of the ultimate use of Federal funds?

Is it or is it not illegal?

What do you think we ought to do about it?

Would you oppose legislation to forbid the use of those Fed funds by foreign branches?

Which of you would like to start on that one?

Mr. McDONOUGH. Sure, I will take a crack at it.

Mr. Chairman, I think the statistics used on the size of the so-called Fed funds market are essentially accurate. It is a market to which foreign bank agencies and branches have access, the ones located in the United States, and many of the foreign bank agencies and branches use it in a very appropriate manner to equalize their day-to-day activity.

I believe that the Mexican and Brazilian banks used it appropriately until the fairly recent past, as their countries began to have balance of payments difficulties. It is certainly clear by hindsight, and probably something that we should have noticed as it was beginning to take place, that they were using—they were rolling overnight money on constant levels and sending it back home for balance of payment support.

Senator HEINZ. How could that not have been obvious?

Mr. McDONOUGH. Well, because of the way the market works—let's say that I take *x* out of the Fed funds market everyday. I don't have to take *x* from the same banks every day, there are enough players in the market that I can take from you today and from Jack Clark tomorrow, and still maintain a constant level. There isn't a surveillance method which makes it possible to spot that.

Senator HEINZ. You know and I know that what you have got are two or three really, you know, competent guys, trading types who are doing this every day. This is a fast market, a lot of information sharing, you know everybody in the market, you are talking to them all the time, you know what's going on. It is like the floor of the New York Stock Exchange, except it is over the telephone.

Now I really find it difficult to believe that people who are in this every day—it is their profession, they have got to know what is going on, they can't be blind, they have got to know what supply and demand is, so they know what in the heck is an eighth over the market, and grab it when they can get it—that they don't know what is going on.

Mr. McDONOUGH. We probably should have been asking our Fed funds trader. In my own case I have to be particularly contrite because they report to me and I spend most of the day on the trading floor.

Senator HEINZ. Would you agree with me that they would know what is going on?

Mr. McDONOUGH. Yes. I should have been seeing that the Mexicans and Brazilians seem to be more active in the market. And we do try to spot that kind of thing. In this particular case we didn't.

Senator HEINZ. In other words, your people knew. You just didn't ask them and they didn't volunteer.

Mr. McDONOUGH. The other thing I would like to address myself to is that we jeopardized the international financial system for an eighth. I think it is a very colorful line and the gentleman who gave it is undoubtedly successful in selling books with that kind of talent.

I do not believe in fact it would probably be——

Senator HEINZ. Speaking of books, it turns out that the person who wrote "The Crash of 1979" was only off by a couple of years. Maybe more people should have read it.

Mr. McDONOUGH. I think you had an earlier question——

Senator HEINZ. The question was, should we ban it?

Mr. McDONOUGH. I think you would be throwing out the baby with the bathwater, really. I believe that the Fed certainly, and the banks who are active in the market should be—the banks should be self policing, and the Fed has the authority to know what is going on.

I don't think for example we should say that the various branches of all foreign banks in the U.S. shouldn't be able to use the Fed funds market. Those are powerful institutions.

Senator HEINZ. If we shouldn't ban them, how should we restrict them?

The Fed is going to come in and say, "Well, we really aren't sure what Congress wants us to do."

What should we tell them to do?

Mr. McDONOUGH. Could I give you a more thoughtful answer to that at some later date?

Senator HEINZ. I'd appreciate that. Mr. Clark, on the very last question?

Mr. CLARK. Yes, sir.

I think the bill should add that the magnitudes involved in the case of Brazil or Mexico, as it relates to the total size of the market were very, very small, indeed. And at least as far as Citibank goes, we include any of those transactions as part of our sovereign risk exposure, so— did you do that, too, in Chicago?

Mr. McDONOUGH. Yes.

Mr. CLARK. The word came up, control. It is already now controlled. Our traders, when they make that kind of a placement with a Brazilian bank have to operate within our total limit. And so it is really a very small segment of the total segment. It did happen, but very small.

Senator HEINZ. You bring up an interesting question. You say at Citibank you do have risk limits. You have the distinction, of course, of having 100 percent or more of your capital exposed in Brazil.

What good are your limits if you get that exposed?

Mr. CLARK. Mr. Chairman, we don't focus on the relationship between capital and exposure in a particular country. What we look at is the extent to which we believe that the country is creditworthy for *x* amount of money.

The Brazilians have an absolutely fabulous record of managing their international financial situation. We have a great deal of confidence in them. We don't feel that we are unduly exposed.

Senator HEINZ. Certainly have an awful lot of people worried about it.

Mr. CLARK. Yes. The trouble with sovereign risk lending is it is really quite an arcane or esoteric subject. There is a lot of misunderstanding about it. And I am always struck by how much concern there is about this type of lending. Yet, as I pointed out in my testimony when you look at the record, you find that this is where the performance has been absolutely splendid.

Where Citibank loses money is down the street, down at 42d Street in the railroad, and where we don't lose money is in Brazil.

Senator HEINZ. You know, my recollection is one of the reasons that American banks weren't deeply involved in the Polish debt crisis as German banks, was not just proximity, but there is in effect for all practical purposes, a sovereign risk limit that inadvertently operates, which is the requirement—I guess it is of Comptroller or the Fed, I forget whom—that says you can't lend more than 5 percent of your capital to any one borrower.

Mr. CLARK. That doesn't apply to this type of lending.

Senator HEINZ. Ten percent.

And my understanding is that there is only one borrower in Poland.

Mr. CLARK. The Foreign Trade Bank of Poland.

Senator HEINZ. Was that a factor?

Mr. CLARK. We never got to the 10 percent. I don't know about Chicago.

Mr. MCDONOUGH. A long way away from that.

Mr. CLARK. That limit was not the reason. I would say the banks were basically concerned about the Soviet umbrella, whether it existed or not. So we have generally been very cautious in our Eastern European lending.

WHY WERE LOANS MADE TO MEXICO AND BRAZIL?

Senator HEINZ. The last question is this: Obviously on the face of it it is really difficult to explain rationally from the standpoint of the stability of the world economic and trading system, why loans were originally made to countries like Mexico and Brazil at LIBOR, or just slightly above LIBOR.

And then at a time when, you know, lots of lending was going on and the debt was increasing—and then now at a time when the LDC's are really in trouble, have tremendous difficulty rescheduling, that their interest rates over LIBOR should be significantly increased along syndication fees, adding in effect to their debt burden.

And, as I think Mr. Clark said, well the reason it has got to be that way is that if it isn't that way, we won't participate.

My question, Mr. Clark, is what choice do you have?

Suppose the Feds said you are going to—

> We do have the authority, you will not increase the interest rate, it is bad for the world economics for you to do so, we sympathize with you but we are not going to let you increase the rate because that is our regulation, and you can tell your shareholders that we are the bad guys, not that you are the bad guys.

What choice would you have?

Would you be able to pull your money out of Brazil?

Mr. CLARK. Mr. Chairman, thank you for your question, because it's terribly important that we be realistic about these things.

I heard some comments during the morning which really weren't realistic.

It happens that Citibank is the agent for the Mexican rescheduling. It happened that on November 16 the Managing Director, Mr. de Larosiere, came to New York and said, "We need $5 billion to redo the Mexican debt situation."

So we undertook that role. Now, that was November 16. And we are still trying to put that deal together.

My hope is that we will get it done by the end of this month.

Senator HEINZ. My understanding is that one of the reasons the Mexicans have been a little unwilling for a lot of it is that they thought that what you were charging them was too high.

Mr. CLARK. I haven't heard that. You know, there are a lot of Mexican officials, and maybe some of them did. But if they did——

Senator HEINZ. My source is a high, high, highly placed Federal banking regulator who——

Mr. CLARK. United States or Mexican?

Senator HEINZ. United States.

Mr. CLARK. Oh, I know who. [Laughter.]

You know, he really knows how we have suffered trying to put this thing together, and I wonder if he still feels that way.

The fact is, these are market forces.

Senator HEINZ. Suffering has very little to do with the question of whether that was the issue or not. You may be suffering.

I can understand exactly de Larosiere calling you up and saying:

> We have a problem, and I need your help in trying to get these Mexicans to agree to some conditionality.
>
> In order for them to do that, you've got to come up with some money. I'll do anything to make it worth your while to do so, so that we avoid a crisis.

That's the kind of pressure he's under. He's an immensely sophisticated, able man working under great time pressure.

Mr. CLARK. He needs someone to reach out to him.

Senator HEINZ. I agree with you entirely.

Mr. CLARK. Mr. Chairman, when I said suffering——

Senator **Heinz**. Clearly, I think you need to go into the dynamics I just described of why you really haven't had much of a choice here.

Mr. **Clark**. Mr. Chairman, when I mentioned suffering, I meant something quite specific. We haven't been able to get participants because they tell us that they are not being adequately compensated for the risks that they perceive that they are taking under these conditions.

We are dealing with basic market forces.

Senator **Heinz**. These are people who have been in it——

Mr. **Clark**. We are only dealing with banks that have been in it.

Senator **Heinz**. That's right. Suppose the Fed just said to them, "Well, I'm sorry, you have to"?

Mr. **Clark**. I really wouldn't be in favor of that. You know, that would be contrary to our whole tradition of division of risk, and private and public sector, and so on and so on.

Someone pointed out we are dealing with private sector money with private individuals, and I think we probably ought to arrive at those conclusions through the full free play of market forces.

I think it would be a tremendous departure from our traditions and it would be bad for the market. It would scare the banks away.

WHAT LOSS IS THE BANKING INDUSTRY TO TAKE?

Senator **Heinz**. One of the free play market forces is that when an industry or a business firm, for whatever reasons, gets into trouble, that takes a loss.

Now, what loss is the banking industry going to take?

Mr. **Clark**. Mr. Chairman, if we felt we have losses on our sovereign risk exposure, we would have written it off long ago.

Senator **Heinz**. It must be some problem. Otherwise this legislation wouldn't be before us.

Mr. **Clark**. Yes, there is a problem. We certainly need to work this out over a period of time, but I don't think it's a problem of writeoffs and losses that's involved.

Senator **Heinz**. You're trying to avoid it being a problem of writeoffs and losses and international catastrophe.

Mr. **Clark**. Yes, sir.

Senator **Heinz**. Let's just talk about the basic free market principle, which is when things don't go right, whether you have been as wise as Solomon or not, and things don't work out right, the temple may come crashing down on you and you pay a penalty; now what penalty, if any, are American banks going to be paying here?

As far as I can tell, it reminds me a little bit of the Chrysler loan guarantee, which was a great deal for the Chrysler management shareholders.

The Congress, this very committee, forced the UAW to reduce its wages, forced the white-collar people to reduce their wages, forced the banks, some of you maybe, to step up with some more money.

It required the dealers to come in with some preferred stock. The only people who didn't have to do anything was the board of shareholders.

Now, Mr. Iacocca is something of a folk hero, because we solved all of his problems for him. Maybe it's a good thing we did, because I doubt that he could have done it by himself.

Why isn't that exactly the same situation here? We're solving all your problems for you, and you're going to look terrific with your shareholders, your boards.

Isn't that going to happen?

Mr. McDONOUGH. If I could suggest an answer, Mr. Chairman. You have one very significant difference from the Chrysler case.

And that is this is an international situation. Even if the Fed said to the banks, "We expect you to stay in on these loans, and we expect you to stay in at the same spread that you were lending at a few years ago," let's say, the markets won't clear because we are dealing with banks from all around the world that have to be in on these operations.

And I suppose one could agree with the theoretical construct that Mr. Volcker's opposite numbers, or Secretary Regan's opposite numbers throughout the world would come to such an agreement.

But I would frankly think I know the world well enough to know that A, it's very unlikely that it would happen; and B, if it did, it would take forever.

I think that the fact that we have so many banks, so many countries involved, if we are really looking at the solution of the problem, which is what we are driving for, market forces work and let the markets clear at the interest rate—at which the lenders are willing to lend and the borrowers are willing to pay; that's your most practical solution.

Senator HEINZ. I have a great deal of sympathy for the regional banks, the syndicated. They didn't make any syndication fees. They weren't lending the Federal funds market.

They relied upon the New York money center banks, principally—I include the Bank of America—we'll throw in your brethren in Chicago—for guidance.

Do you think that they really had a full appreciation—Mr. Clark, let me ask you—what they were getting into when they joined with you in places like Mexico and Brazil?

Were they knowledgeable?

Mr. CLARK. Mr. Chairman, it certainly is true that they don't have the departments to do the indepth studies that we did.

We have made a tremendous thing out of our sovereign analysis, and no doubt they participated in some of those syndications on the assumption that we had done our homework.

Here again, the Institute that Bill McDonough mentioned is where we hope now in the future—this goes back to your first point about trying to handle this thing differently another time around.

We do hope that within the Institute we will have as members virtually all of the 1,000 or so banks that do sovereign risk lending and they will have access in the future to the data base that we all are going to have.

So we hope we will have them more in a position to do their own independent analysis the next time around, than they could have done this time.

Senator **Heinz**. Gentlemen, thank you very much. I appreciate your time, your testimony. It's been very helpful.

[Whereupon, at 1 p.m., the hearing was adjourned.]

[Response to written questions of Senators Heinz, Garn and Proxmire to William J. McDonough follows:]

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April 7, 1983

CONGRESSIONAL QUESTIONS
Senator Heinz
Page 1

1. Question

Felix Rohatyn has written that "we are witnessing a loss of confidence in our banking system which, if allowed to continue, could have serious repercussions." Do you believe that the IMF/GAB quota increase alone is enough to restore confidence, or will some more fundamental reform be necessary, for example, tougher regulation of foreign loans and exposure?

Answer

Increased resources for the International Monetary Fund are necessary to strengthen the international financial system. At least as important to the smooth functioning of the system will be continued coordination among international financial institutions, central banks, commercial banks and governments; moreover, debtor countries must adjust their economies to rebuild their debt service capacity. At the present time, more fundamental reform of the system does not appear necessary. Moreover, it is important that changes in bank regulation do not undermine the coordination which has evolved between commercial banks and official institutions or prevent banks from continuing to play a constructive role in coping with international financial problems.

2. Question

Only the top 300 U.S. banks have any sort of international presence and probably none beyond them have any capacity to do sophisticated analysis of the risks involved in international lending. Yet more than 1000 U.S. banks are exposed in Mexico. Do you think that the regional banks had a full appreciation of what they were getting into when they joined with the big banks in loans to places like Mexico and Brazil?

Answer

A great many individuals and companies, including banks of various sizes, have chosen to do business or to invest in enterprises in countries like Mexico over the years. Many regional banking institutions, for example, became involved as their U.S corporate customers explored the potential of these markets and as they subsequently developed strong working relationships inside those countries.

It is probably true, however, that some banks, corporations and individuals taking cross-border risk did not thoroughly anticipate, and so did not fully appreciate, the nature of the risks they were taking.

3. Question

How do you set your country loan exposure limits?

Answer

At First Chicago, country limits are set as part of a broader country risk management process. The procedure brings together detailed analyses and forecasts of economic and political developments in individual countries with assessments of marketing opportunities. The analytic process aims at judging the future capacity and willingness of a country to maintain its aggregate debt service payments. Senior management meets monthly to set country limits in light of these assessments; limits are set on aggregate loan, deposit and investment exposure. Country assessments, limits and strategies are reviewed frequently, with all country limits and risk classifications formally discussed at least once per year. In addition, country risk issues are discussed regularly with the Board of Directors.

4. Question

How important to you is the advice of regulators in setting those limits?

Answer

The regulators' views of country creditworthiness are an important part of the Bank's overall risk management process. These views, as communicated by the National Bank Examiners, are incorporated into our analysis of individual countries; however, we would feel it imprudent to rely excessively on any single source of advice or information.

5. Question

In view of the current problems in Mexico, Argentina, and Brazil, among others, do you think it would be unreasonable for Congress to provide a mandate to the Federal Reserve to set more stringent limits and to enforce them?

Answer

The regulatory agencies already have a mandate to oversee the international activities of U.S. commercial banks. This mandate, which for national banks is implemented by the Comptroller of the Currency, should be sufficient for regulators to maintain the credibility and integrity of the banking system. In particular, a mandate for the Federal Reserve to set and enforce country limits is not necessary. Moreover, such limits could put American banks at a competitive disadvantage and curtail the availability of finance to support U.S. exports.

6. Question

It is my understanding that "reserving against losses" varies greatly from bank to bank. Could you briefly describe your bank's practice with regard to reserving against problem loans?

Answer

The Bank scrutinizes its credit portfolio on a continuous basis for potential losses. Once each quarter, the Bank formally reviews its higher risk credits, asset by asset, to determine possible losses. Based upon that review, the Bank determines its current losses and potential future losses, and establishes an appropriate reserve.

7. Question

Do you think it would be reasonable for the Congress to give the Federal Reserve a mandate to make reserve against loan practices uniform?

Answer

Existing regulatory controls are sufficient, however, there are probably some benefits to having more uniform practices as regards disclosure of exposure and accounting treatments.

8. Question

According to a recent survey by the "Group of 30," an informal bank "think tank," most bankers feel that the risk of lending has increased over the past five years and is likely to get even more risky over the next five years. Wouldn't it make sense to begin to introduce more conservative and prudential regulatory guidelines under such circumstances?

Answer

Over the past several years the world economy has suffered through rapidly accelerating oil prices, prolonged recession, high inflation, and high nominal and real interest rates. These have contributed to an uncertain economic environment both domestically and internationally. In this context, it is appropriate for banks to manage themselves more conservatively and for regulators to adjust their own procedures to reflect increased systemic risk. In fact, there is considerable evidence that both banks and regulators--with respect to international as well as domestic activities--have indeed done so over the past several years. At the same time, it is important that American banks continue in the international arena in order to maintain the competitiveness of American exports and to promote economic recovery.

9. Question

Is there a certain point of country risk exposure, in relation to your capital, past which you no longer are able to say "no" to a country which needs additional loans, since any default on the part of the borrower threatens to take the heavily exposed bank with it?

Answer

We set country limits in relation to our judgment of a country's willingness and ability to service its aggregate debt on a timely basis. Incremental lending decisions are taken in the context of these assessments. This process leads to geographic lending concentrations, but these concentrations themselves do not force us to participate in additional lending. Highly indebted countries may well enjoy a degree of leverage over the system as a whole, but not over individual financial institutions.

10. Question

How could we improve disclosure requirements so that the total amount of debt owed by each borrowing country might be known (without a long time lag) by national and international authorities?

Answer

In practice this is a difficult undertaking, not only because it involves some sort of uniform reporting by sovereign and private entities outside the U.S., but also because some standardization of accounting practices would also be required.

However, to the degree that agreement could be reached among the major lending and borrowing countries and involved private sector entities, a broadening of data and acceleration of reporting and publication would be a major improvement. First Chicago would support increased and improved information sharing.

11. Question

What are the economic advantages and disadvantages of the proposal to require banks to convert short-term loans to long-term loans and reduce the interest rate? How would this affect interest payments of countries such as Mexico and Brazil? Would this proposal encourage borrowing countries to delay debt servicing payments in order to benefit from restructuring?

Answer

As a general rule, debtors benefit from lower interest rates--unless the price of renegotiation is reduced further availability of credit. The danger in many of the proposals which have recently been discussed in the press to convert short- and medium-term debt into long-term financial obligations with reduced interest rates is that less credit would be available to some debtor countries. Incentives to lend are reduced when yields are reduced, particuarly where credit risks are high. Official international financial institutions lack sufficient resources to replace commercial bank lending. Less credit would exacerbate the difficulties of effecting a return to economic viability in some of the debtor countries, thereby adversely affecting world trade and world economic recovery.

12. Question

What changes have you made in your bank practices to make more informed decisions about lending to LDCs which seem to have difficulty in paying debt?

Answer

Our country risk management process was put in place a number of years ago; since then First Chicago has devoted considerable resources to building a professional capacity to analyze economic and political developments which affect country creditworthiness. More recently we broadened senior mangement's participation in the process, which now involves seven of the most senior officers of the Corporation. Last year, we established a sovereign risk rescheduling group to focus our involvement in troubled country situations which has become an important part of our overall risk management effort.

13. Question

What are the implications for your bank of continuing to loan to LDCs in view of the already perceived risk of their inability to pay old debt?

Answer

We will continue to assess countries' capacity and willingness to service debt, and to base our lending decisions in large part on these assessments. Our expectation is that with recovery in the U.S. and world economy, the debt service ability of many countries will improve. Thus we continue to look for new lending opportunities, but--in light of current financial and economic circumstances--the overall growth of our international portfolio is likely to be slower than over the past several years.

14. Question

What is the relationship between high U.S. interest rates charged by U.S. banks and these banks' outstanding and significant high risk loans to LDCs?

Answer

Interest rates reflect risk, and international financial instability has undoubtedly contributed to high dollar interest rates. However, if American banks were less exposed, the overall "debt problem" would not necessarily be smaller. In light of the interdependent nature of international financial markets, financial conditions in the U.S. would still be affected by debt service problems abroad. In other words, U.S. interest rates reflect international financial conditions because of the global nature of dollar financial markets, as well as the level of American banks' international lending exposure.

15. Question

Is it desirable and feasible to attempt to coordinate internationally the supervision and regulation of international banks to reduce the risks of international lending?

Answer

Closer international regulatory cooperation and coordination is highly desirable. Over the last several years, the work of the Bank for International Settlements has helped to bring different regulatory systems closer together and at the same time has improved the flow of information among regulatory agencies. It is particularly important that regulators jointly address issues which arise at the intersection of national banking systems such as the supervision of international consortia banks and the activities of banks active in international banking centers.

CONGRESSIONAL QUESTIONS
Senator Proxmire

1. Question

When domestic credits are weak, bank examiners classify loans as substandard, doubtful or loss and loans are required to be written-down. I understand that the regulators are reluctant to classify countries as loss. Would it not make good sense for the Federal Reserve to have the authority to require reserves to be set aside by banking institutions to reflect the risk in international lending that are problems?

Answer

Our loan loss reserve is set to reflect our best estimate of likely losses domestically and internationally. This reflects an assessment of the quality of each credit as well as of the Corporation's overall historical loss experience. We write off international loans (to companies or countries) when it is appropriate, even if the national bank examiners have not classified the credit as "loss." The regulators and the Corporation's accountants regularly assess the adequacy of the reserve. Thus, the mechanism already exists for banks to establish appropriate reserves against possible loan losses.

2. Question

According to the Federal Reserve, the nine largest U.S. banks have outstanding loans to Mexico, Argentina and Brazil in an amount equal to 112.5 percent of their capital. Do you agree that there is a risk that can be described as a country risk? If so, should not the Federal Reserve have the authority to write regulations governing concentrations of credit to reflect country risk?

Answer

Bank regulators--the Comptroller of the Currency, Federal Reserve, Federal Deposit Insurance Corporation and state banking authorities--already have sufficient authority to discourage inappropriate lending concentrations domestically and internationally.

3. Question

Recent press reports reveal that in connection with restructuring loans to countries that cannot be paid as originally contracted, the bank derives large up-front fees that are taken into the income account in the first years. Thus, at a time when the loan portfolio may be weaker, the bank's income appears to be increasing. Should not the Federal Reserve adopt a rule requiring such fees to be amortized over the remaining life of the loan?

Answer

Accounting for fees and other payments made in conjunction wth any loan, whether restructured or not, is subject to the scrutiny of a number of internal and external auditors, regulatory agencies (in our case the Comptroller and the SEC) and others, including depositors and security analysts who concern themselves with the quality of earnings. Consequently, we believe that if any institution adopts an earnings recognition method that is inappropriate, that stance will be appropriately challenged. First Chicago amortizes fees in those cases where a more conservative accounting posture is warranted.

CONGRESSIONAL QUESTIONS
Senator Garn

1. Question

LDC medium- and long-term debt was about $630 billion by the end of 1982. They owe an additional $70-$100 billion in short-term debt. Four-fifths of the aggregate debt is owed to private financial institutions. Is this four-fifths ratio a share that the private financial markets will be prepared to maintain or increase in the foreseeable future?

Answer

Over the next several years, the level of international bank lending is likely to fluctuate sharply; on average there is likely to be a slowdown in net lending, compared to the 1973-82 period. Unless there is an unexpected increase in official lending and aid, the overall amount of financing to developing countries will probably grow only moderately. Thus, even if commercial banks' lending grows relatively slowly, the share of total lending could remain unchanged.

INTERNATIONAL DEBT

THURSDAY, FEBRUARY 17, 1983

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,
Washington, D.C.

The committee met, at 9:30 a.m. in room 538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Mattingly, Hecht, Proxmire, Riegle, Dodd, Sasser, and Lautenberg.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Today the subcommittee will hold the third of its oversight hearings on the international financial situation and the participation of the United States in the International Monetary Fund. So far we have heard from the administration, bankers, and bank critics. Today we will receive testimony from the bank regulators. Our witnesses are distinguished, and it is an honor to have them here today.

The role of the Nation's bank regulators in the current crisis is direct and significant. Indeed, many critics have argued that the U.S. bank debt problems would not have gotten to their present dangerous stage had our bank regulators not been asleep at the switch. The primary mission of our bank regulators is the safety and soundness of our banking system. Yet, we have been told of bank after bank whose entire capital is exposed in one or two or three countries, shaking international borrowers. To say the least, therefore, this has hardly been bank regulation's finest hour.

This committee has received information that countries that are now in deep financial trouble have been using the agencies and branches of their banks to draw billions of dollars out of our Federal funds market to finance their own foreign exchange imbalances. In clear violation of the purpose of this market, the Federal funds market as it is called, those foreign agencies withdrew as much as $10 billion, while both U.S. regulators and banks were either ignorant of these transactions or failed to respond to the risks that they posed.

On Tuesday, Mr. Martin Mayer testified and described this episode as "a disgraceful spectacle of the big New York banks and, indeed, the Federal Reserve, leaning on our regional banks to continue the dangerous practice of selling Federal funds to foreign purchasers who were using them for purposes quite illicit by the generally accepted terms and conditions of this market."

This regulatory failure, if the record is accurate as described, is not unique. What we have is an international financial crisis brought on by a failure to stop at the prudential limits, even though the purpose of regulation is to determine just what those prudential limits are. Mexico did not get into as much financial difficulty with its first $40 or $50 billion of debt as it did with its last $10 or $20 billion of debt. Likewise, it is hard to believe that there is anything that could be called an effective country limit if when we discover, as we did on Tuesday, that our largest bank in the United States has 100 percent of its capital exposed in just one country, Brazil.

Having noted this, however, I must add that if our regulators aren't clear on the fact that the mission that we have chartered them to achieve is that of safety and soundness of our banking system, then clearly Congress is going to have to take some additional steps to make what we thought was apparently clear more clear. And several of my colleagues and I do plan to introduce legislation. Indeed, we have introduced legislation, in addition to any legislation that will come before us for the IMF increase, to direct bank regulators toward these kinds of problems. Yesterday Senator Proxmire and I did introduce a bill that targets what we believe to be three of those needs.

Let me comment briefly on that legislation. First of all, the bill would empower the Federal Reserve to establish firm guidelines on country lending limits. The legislation does not attempt to arbitrarily assign those limits itself. It would allow the Fed to do that. That is in keeping with advice we received from Secretary Regan earlier this week where he agreed that it is appropriate for Congress to require the Fed to establish loan limits but warned against Congress doing it.

Second, the bill would mandate that the Federal Reserve require banks to establish special loan loss reserves to be charged against bank capital whenever the Board determines that the aggregate amount of external debt incurred by the public and private borrowers in a country is at a level where there is a substantial likelihood that such debt cannot reasonably be expected to be repaid. Again, that would be left to the Federal Reserve Board's judgment as to when such a point is reached and what the amount of those reserves should be.

Finally, the bill calls upon the Federal Reserve to promulgate regulations to require that fees resulting from loan reschedulings should be amortized over the life of the loan rather than taken and recognized as one-shot earnings. This provision would insure that earnings statements more accurately reflect the quality of both the bank earnings and assets and would minimize the incentive for bank syndicators to continually be under pressure to make one syndication after another in order to make profits look better and better.

These provisions, I believe, will make it clear to our bank regulatory agencies, including the Fed, what congressional intentions are, while still giving them the flexibility to implement these directives according to their special knowledge and experience. I would like to emphasize that I and Senator Proxmire and the other members of this committee are open to suggestions for better ways to deal with these issues. But my principal concern is that, in addition to resolving our current crisis, we must do our utmost to insure that it is not repeated.

Let me yield at this point to my colleague, Senator Proxmire, who I understand has an opening statement. And then I understand Senator Proxmire has to go to the Rules Committee to make sure that this committee will be operating at the first of March. It won't operate if we don't get any money from the Rules Committee to turn on the microphones.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Yes, I feel pretty hypocritical. I'm going to make a pitch for more spending.

Mr. Chairman, I want to congratulate you for devoting a full morning of our hearing schedule to hear from the bank regulators concerning the foreign lending issue. I think you will agree with me that regulatory changes are needed if the IMF quota increase is to be approved. For that reason, I was glad to join with you in introducing the International Bank Lending Reform Act that we have introduced.

Let me cite just a few facts that raise serious questions about the adequacy of our present regulatory system.

First, the nine largest U.S. banks have loaned 222 percent of their capital to the non-oil developing countries as of mid-1982.

Second, these same nine banks have loaned over 112 percent of their capital to just three countries—Argentina, Mexico, and Brazil, according to the Fed figures. I have seen other reports indicating the figure is 130 percent.

At least one large U.S. bank reportedly has 78 percent of its capital loaned to Mexico alone.

Even though danger signals were apparent to all but the wilfully obtuse, U.S. banks increased their exposure in Mexico during the first half of 1982 by $3.8 billion. This represents an annual rate of increase of 21 percent.

Over the last 4 years, our banks increased their loans in the non-oil LDC's at an annual rate of 21 percent, while the capital of these banks increased by only 9 percent a year.

Mr. Chairman, as we go through these hearings, I think we must get the answer to a very simple question: Where were our regulators? How is it possible for our banks to have become so overexposed on foreign loans without the regulators blowing the whistle? As far as I can tell, the regulators were not unaware of the problem. They advised, they monitored, they cajoled, they encouraged—in fact, they did everything except what they are paid to do, and that is to regulate.

One reason for this abysmal failure of our regulatory system is the division of authority among three separate and independent agencies. When authority is divided three ways, much of the time and energy of the regulators is spent bickering among themselves. When authority is divided three ways, no agency feels responsible for the total foreign debt position of U.S. banks. And in the end, no one agency can be held accountable by the Congress.

One of the key features of the Heinz-Proxmire legislation is that it assigns authority over international lending to a single agency—the agency that has the greatest expertise in international finance—the Federal Reserve Board. I am convinced that we will never get the job done unless we assign responsibility to one agency, give it a clear mandate to regulate foreign lending, and hold it strictly accountable.

Mr. Chairman, I look forward to hearing the testimony from today's witnesses and to developing a continuing discussion of the legislation we have put forward. I will be back shortly.

Senator HEINZ. Senator Lautenberg.

Senator LAUTENBERG. I have no opening statement.

Senator HEINZ. Senator Dodd.

Senator DODD. Nothing.

Senator HEINZ. Chairman Volcker, this is the second time the committee within about 24 hours has had a chance to welcome you. Welcome back.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you. I wonder if it's worth reading even the relatively short statement I have after you have had the testimony that you have had.

Let me just pick out a few points. I outline, in the first few pages of my statement, the general approach toward this problem of pressures in the international financial system. I have gone over that before, and I'm sure others have, with this committee or with other committees.

I submitted to the committee earlier the statement that I delivered before the House Banking and Currency Committee which discussed at length some tentative ideas in connection with the supervisory area. I did not plan to review that in my preliminary statement today because you have that material.

But let me just say, in connection with this problem that has arisen, that I think much of the lending of banks over this past decade has reflected a constructive response by the financial system to the need to ease adjustments associated with the world oil crisis. International lending will continue to have to play an important role in a developing world economy.

Of course, there can be excesses, and some of the lending proceeded on assumptions that, in retrospect, seem invalid. None of us enjoys perfect foresight, and it remains central to our financial and economic system that the individual lenders reach their own credit judgments.

But it is the responsibility of government to establish and maintain ground rules and procedures that, without stifling the market, provide assurance that the stability of the system as a whole can be protected against the dangers of excessive concentration of risk, and that the element of risk is appropriately weighed. While our present supervisory approaches are aimed at that objective, the rapid development of international lending and today's problems do point to the need for careful review of present policies. Possible modified or new approaches—touched upon in my earlier statement—are under intensive review by the supervisory agencies, and I expect to be able to report conclusions to you in a matter of weeks.

THE DANGER OF OVERREACTION

At the same time, the danger of overreaction—of encouraging inadvertently an abrupt retreat from lending—is equally real. The hard fact is few borrowers, at home or abroad, can suddenly repay substantial debts accumulated over years. An attempt to force the process would be doomed to failure, because borrowers need time to make the adjustments to earn the funds or to restore their market access. What may seem logical and appropriate to an individual bank in demanding payment, if generalized, would place such strain on the system as a whole that it, and the individual banks within it, could only be damaged.

As I noted earlier, the parties immediately at interest in resolving the international debt problem—lenders and borrowers, governments and the private lending institutions, and international organizations—have been acting cooperatively to deal with the major points of pressures to the financial system. The IMF stands in the center of this effort, and it has responded with force and leadership.

The remainder of my statement discusses the importance of dealing with the IMF need for additional resources. And that, of course, is a matter that I hope this committee will act upon at an early date. I do not think that the United States—we are the leaders, financial, political, and economic, of the rest of the world—can escape the responsibility of leadership and participation in this particular effort, if we want it to succeed, and it is in our own interest that it succeed. It is in that context that I am delighted to be here this morning.

I might say, too, Mr. Chairman, you have emphasized the importance of safety and soundness and the responsibility of the regulators, and I very much welcome your statement in that connection. I fully accept that. It is not only relevant in this area but in other areas. At the same time, it has to be balanced against letting the system work. There has been a certain deregulation wind in the air. I think Congress has been involved in that as well. When one looks at problems of this sort, the time to worry about them is, I suppose, before they begin. It is a little late when the problem has developed in full-blown form.

Let me just say in that connection, the Congress itself took some actions last year in other areas that we in the Federal Reserve were not very happy about, in terms of future safety and soundness considerations. I can think of a very considerable expansion of the legal lending limits for American banks. That seems to be an area that you think is relevant in the international area. And in the area of export trading companies, we were not opposed to export trading companies, but we wanted to make sure that safety and soundness considerations were clear in the minds of the Congress as banks got into that area. The legislation that was passed, frankly, did not reflect our concerns as to what might develop in the future in that area.

I suspect you will be faced with legislation this year sponsored in part by the banks which are looking for additional powers. I think some of those will be well justified. I don't know precisely what they are going to ask for, but I would suggest you look at those areas with some care in connection with your obvious concern about the future implications for the safety and soundness of the banking system. I think you might want to look at the reverse, too, to nonbanking institutions, nonregulated institutions, that in a sense are getting into the banking business through the back door and going around the regulatory structure.

I think this is an area that we have to work on, and I share the concerns that you expressed at the start, not just in this area but in other areas.

Senator HEINZ. Mr. Chairman, the process you have just described from the export trading company legislation which was enacted in September or October—I think the President signed it in early October of last year—the increase of the lending limit was also something that came in very late last year——

Mr. VOLCKER. That is correct.

Senator HEINZ [continuing]. Clearly antedated the kinds of problems we are talking about with the international banks.

Mr. VOLCKER. Yes.

Senator HEINZ. When we had Secretary Regan before us on Monday, he was asked a very direct question, exactly the one you raised: With deregulation in the wind, did some of this deregulation spill over in any way into international bank lending? And he said no, absolutely not. The main spirit of deregulation, he pointed out, had been aimed at deregulating the retail depositors' kinds of concerns, and he indicated very clearly that in terms of international bank lending there had been no signals sent and no legislation sent down or acted upon, other than those two you mentioned at the very end of last year, that in his judgment had any influence on this. Would you agree or disagree with that?

ADDITIONAL LEGISLATION UNDER REVIEW

Mr. VOLCKER. If I understand you correctly, the regulators, to the best of my knowledge, have not requested any legislation heretofore on this international lending area. We have, obviously, among us, been working on this problem and, indeed, we have been rather intensively involved in recent years, reflecting some of the concerns that you suggested. Someone can look back and say—I look back myself and say—"Were we forceful enough? Were we aggressive enough?"

That is obviously a legitimate question in retrospect. I don't think it's correct to say we had no concern. We have spoken about it in public as well as in private in connection with banks. We have not asked for additional legislative authority, that is quite clear. What we have under review is whether we need additional legislative authority or not; whether we can use our other regulatory supervisory instruments is a matter which is under consideration right at the moment.

Senator HEINZ. Well, clearly, you are taking seriously the question of whether our system has resulted de facto in some kind of failure of bank regulation. Let's assume for the moment there is some kind of failure, without pointing fingers at whether it's at the Fed or the FDIC——

Mr. VOLCKER. No, no, that is not the point at all.

Senator HEINZ [continuing]. Or someplace, but let's just ask ourselves the general question, which is this: If there is a failure, it can come about in one of two ways. Either the regulators in fact know how to regulate but the banks didn't take the advice of the regulators, or the regulators failed to properly instruct the banks. Of the two, which would you think more nearly describes the problem?

Mr. VOLCKER. You say, "properly instruct the banks." In some sense we are not in the business or haven't conceived of ourselves in the business of instructing the banks.

Senator HEINZ. Instructed in the educational sense of the word.

Mr. VOLCKER. All right, in the educational sense of the word. First of all, you say that this international lending is a failure. Everything is relative in this world, I guess. International lending is part of the world in which we live. It has a very constructive role to play in the world economy. It can play a role to the benefit of the United States, and it has played a role to the benefit of the United States. One is talking about a sense of proportion here, I suppose, and how to strike that proportion consistent with the general philosophy that in the end the credit decisions of the banks belong to the banks. But in some cases limit can be put upon that exercise of discretion.

I think we can learn out of this experience. We are learning out of this experience, and we hope to have a good balance in the future; that is our common goal.

Senator HEINZ. What you are saying is that you would have liked to have had better foresight, you don't admit that you failed in any way, you don't admit that you don't have adequate information, you don't admit that you didn't tell the banks they had some problems. From our point of view, Mr. Chairman, I hope you understand that given the mission that we charged the Fed and the other regulators with, to insure safety and soundness, that your conclusion would to us be soft-pedaling the problem.

Mr. VOLCKER. We are not suggesting you soft-pedal the problem. Since I have already interrupted, perhaps I could make a couple of other points.

Senator HEINZ. I thought you had finished with your opening statement.

Mr. VOLCKER. I have. Go ahead.

Senator HEINZ. Let's turn to some of the specific issues. To my view, there are four. I referred to all four of them in my opening statement. But let's start with the one on Federal funds.

To expand a little bit on my reference, it was Mr. Martin Mayer who on Tuesday testified to what he thought to be the gross abuse of the Federal funds market by agencies and branches of foreign banks. Funds borrowed in that market apparently reached as high as $445 billion on one occasion last September. According to Mr. Mayer, in 1981–82, branches of the Mexican and Brazilian banks used their access to this market to fund their nations' growing exchange deficits, and some $10 billion seems to be involved in doing that. He claimed that that happened, with Mexican-Brazilians paying an extra eighth.

NATION'S FINANCIAL SYSTEM IN JEOPARDY

But it seems, irrespective of what they paid, that practice seems to put our Nation's financial system in jeopardy, and clearly this is what I call overnight money. My understanding is it's not supposed to be used for financing the deficits of other countries, and my question is: Shouldn't Fed funds be clearly restricted solely to domestic purposes?

Mr. VOLCKER. I don't think you can restrict Federal funds in quite that way. Let me say I think the focus on Federal funds as a technical description of this is much too limited. But I think Mr. Mayer has put his finger on a problem, which I would refer to as the interbank deposit problem as well as the interbank lending problem. Most of this is not Federal funds; it is interbank deposits. It may be lent for 1 month, 3 months, 6 months.

There is no question that foreign banks in general have expanded rapidly in the United States in recent years, that banks from some developing countries have participated in that expansion—most of it quite recently—and that, looking at the situation now, as I see it, those banks or their United States branches and agencies were not adequately diversified, that in fact they had a large proportion of their assets in loans to their home countries. I think that that is basically the problem that Mr. Mayer was referring to.

I think, over a period of time, that does raise questions about the appropriate method of supervision of these banks; that is certainly an area of concern to me and that we will want to be looking at. I would point out that we have no direct supervisory authority over those institutions. While legally they can be supervised directly by a Federal agency, most of them are under State supervision, and that is specifically provided for in the International Banking Act, so in an immediate supervisory sense, we and the other Federal agencies are in a secondary position. This has grown up rather rapidly as part of the general policy of permitting foreign banks to operate freely in the United States.

There is another aspect that runs through all of this that needs a lot of emphasis. From the standpoint of the general banking system, it really doesn't make a lot of difference whether those banks are operating in New York, San Francisco, Los Angeles, Chicago, whether they are operating in London or the Cayman Islands. Our regulatory authority over foreign banks, speaking broadly—whether State or Federal authority—obviously runs to their operations in the United States.

If there is a matter of concern here—and I think that there is in the broader sense—it is an example of the fact that in the international banking area, to really be successful you've got to get cooperation and coordination over a large number of countries, and that obviously complicates the problem.

Senator HEINZ. Well, the first question is: Is this a sound or unsound practice to let countries that have severe foreign exchange, balance of payments, risky debt repayment problems, use the ultimate in short-term borrowing, overnight deposits and transactions, to finance a continuing long-term problem.

Mr. VOLCKER. I haven't got a statistical analysis, but I think your focus is probably wrong if you're talking about overnight deposits. They were short-term deposits, no doubt about that.

Senator HEINZ. Very short.

Mr. VOLCKER. But I'm not so sure they were so much overnight, although I'm sure they are in the Federal funds market like the American banks are. Basically they were financing with bank deposits.

Senator HEINZ. This question is directed principally at the use of those very short funds.

Mr. VOLCKER. I am suggesting that that focus is probably wrong. But the problem is the same, whether it's a short-term bank deposit or overnight Federal funds.

Senator HEINZ. Surely you don't agree that it's good for the international lending system to finance with very short-term instruments things that are very long-term ones.

Mr. VOLCKER. All banks, I'm afraid, do that. I think the problem is the diversification on the other side of the balance sheet and having appropriate liquidity.

I can sit here, and ask in retrospect: Was there appropriate liquidity? Was there adequate diversification on these foreign banks' operations in the United States? When they get in trouble or are risky countries you know you have a problem. But the nature of this thing is you've got to worry before they get to be risky.

Senator HEINZ. I agree with you, but I think we have to nail down this practice, because I believe it's a very dangerous one. If, in fact, $10 billion was on loan to just two countries in the way of overnight deposits——

Mr. VOLCKER. That is not true.

Senator HEINZ. Mr. Chairman, just a minute. Let me try and explain to you my concern so you can react to it. And if, as the Mexicans or the Brazilians threatened to do on one occasion—or the Argentinians, I guess, actually did do it for a few days; they said, "I'm sorry, we are just not going to pay anything back"—would you think that that might have a somewhat chilling effect on this particular market?

Mr. VOLCKER. Yes.

Senator HEINZ. All right. That's the point.

Now, your second point was, "Well, other people will be doing this. This is an international financial situation. We are not the only players in the game Our banks have to be competitive." But it doesn't seem to me that being competitive is a license to engage in dangerous practice.

Mr. VOLCKER. Well——

Senator HEINZ. I'm just making my observations so you understand where I'm coming from.

Finally, it seems to me you have said you don't think this is appropriate authority to do something about this, and I'm asking you—and this is my question—do you want some authority to do something about this?

Mr. VOLCKER. We may. I am not certain that we need it, but we may, and that is certainly one of the areas I want to look at.

Senator HEINZ. My and Senator Proxmire's bill, the International Lending Reform Act, looks into three other areas: loan loss reserves, establishment of country limits, and the problem of the amortization of fees.

COUNTRY RISK RANKINGS

I'd like to discuss countries with you. Are there currently any plans to construct a country ranking on a country-by-country basis at the Fed? Does the Fed have any plans or have you already constructed a country risk ranking on a country-by-country basis?

Mr. VOLCKER. We look at countries, country by country. We look at the risks. I don't think we list them and say this country is number one, for this is number 100 in the risk bracket. We look at them and make qualitative——

Senator HEINZ. You put them in categories?

Mr. VOLCKER. In broad categories, yes.

Senator HEINZ. Is that list shared with the banks?

Mr. VOLCKER. It is not shared directly with the banks, but it is reflected in whether a comment is made on the bank's loans to that country.

Senator HEINZ. Was that procedure in effect over the last several years?

Mr. VOLCKER. Yes.

Senator HEINZ. Why didn't that procedure warn off banks?

Mr. VOLCKER. You say "warn off;" it was designed, obviously, to introduce a cautionary note, and one of the questions is were those cautions forceful enough? Is that the best way to go about it, or should you be more arbitrary? We were trying, obviously, not to be arbitrary, but to provide some cautionary notes in appropriate instances. That is the way the system, which was introduced in 1979, is fashioned. And now, obviously, you ask can we make improvements in that system? That is what it was designed to do.

Senator HEINZ. I gather you would agree it would be a good idea to be a good deal stronger in informing banks of what these lists are, what they really mean, and what the confidences are, and that you would like additional mandate to do that; is that correct?

Mr. VOLCKER. I think that's fair, yes. There are a lot of questions as to just how to make these fine judgments among countries in a very uncertain world, based on qualitative evidence. But in general, yes, I agree with the thrust of what you say.

Senator HEINZ. Now, there are supposed to be, or we have been told by bankers that there are country limits that they observe themselves. In fact, Citicorp was here, and they said, "We have a loan loss limit," and they are very proud of their loan loss limits, and I was somewhat stricken by the fact that their limits allowed them to get over 100 percent of their capital exposed in one country alone, Brazil.

What do you think of those kinds of loan loss limits? Do you believe that they are adequate?

LOAN EXPOSURE LIMITS

Mr. VOLCKER. Loan exposure limits.

Senator HEINZ. Loan exposure. Excuse me, I didn't mean loss. It may turn out to be that way.

Mr. VOLCKER. That is, in fact, an area that we look into. We consider that very important—that is true of all the banking agencies—in our examination process, to review the way the banks themselves go about analyzing these credits, whether they have a system for country limits, how they arrive at those limits, whether the board of directors has been involved, and that kind of thing. We consider that an important aspect of the examination process, particularly because, I think it's fair to say, that the idea of an exposure limit always carries the danger of being confused with a marketing target.

Senator HEINZ. My time has expired.

Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, I said in my opening statement that the regulators are not unaware of what I think was the overexposure, what seems to have been the overexposure, of foreign loans of the banks. And as I said, they advised, they monitored, they cajoled, they encouraged, and they didn't get any results.

It reminds me of Dr. Doolittle's observation about women in "My Fair Lady" when he said, "She will ask you for advice, your reply will be concise, and then she will do precisely what she wants."

It seems to me that would be the effect of bank regulation.

You stated in response to a question of Senator Heinz that a legitimate question in international lending is: Were the regulators forceful enough? But what is the answer to your question? Were they?

Mr. VOLCKER. I suppose, in retrospect, probably not.

Senator PROXMIRE. Well, you say "probably not." Let me tell you what the General Accounting Office found.

> The U.S. bank regulatory authorities have adopted a uniform examination system for evaluating and commenting on country risk to U.S. banks of relatively large foreign lending. GAO found that the system's objectives need to be better communicated if standards of administration are good but could be improved, and its impact is questionable.

Now, you say "probably not." What should have been done?

Mr. VOLCKER. That's what we are looking at right now. I think there are two different very broad approaches you can take, and they are not mutually exclusive. You can build on the kind of approaches we have had in the past and in effect be more forceful. That involves making selective judgments among countries, and the kinds of problems that entails have to be balanced against the benefits.

The other thing you can do—and again the two approaches are not mutually exclusive—is build incentives or disincentives more arbitrarily, if I may use that word, into the system. That gets you into the area of reserves, capital ratios, the question of the treatment of front-end fees that you brought up in your bill. You establish a structure that changes the incentives, the risk-reward ratios, a bit for the lenders.

Both of those areas are being looked into.

Senator PROXMIRE. One of the aspects of being more forceful and effective in getting results would be to take a look at the fact that we now have a cooperative venture among the three regulatory bank agencies. Arthur Burns, who was a long-time critic of the three-agency regulatory structure, said the system causes competition in laxity.

REGULATORS NOT FORCEFUL ENOUGH WITH BANKS

It's clear from your own statement and the GAO report that the regulators may not have been forceful enough over the years with the banks in foreign lending concentration.

What is your reaction to our proposal to provide guidelines on country risk lending in the Federal Reserve exclusively so that you don't have this division of authority?

Mr. VOLCKER. I think on the face of it putting the authority in one agency has advantages, whatever agency that may be. Looked at from that point of view, it's very straightforward. I think the only question that arises is whether you feel that that is consistent with the more general approach toward banking regulation and whether it could be fit into the existing division of authority. I think you could do it either way.

Looking at this problem in isolation, I think there are advantages in the approach of centralizing. But the question doesn't stop there; it's whether you want to accept or reject the more general banking supervisory structure, because I think we can work it——

Senator PROXMIRE. Well, we have made exceptions to the division—the bank holding companies, for example, are concentrated in the Federal Reserve Board.

Mr. VOLCKER. That is correct. There were exceptions made before.

Senator PROXMIRE. That has worked very well. I don't think anybody now argues that ought to be divided between the three agencies. I haven't heard too much of that. I suppose there is some of it.

Mr. Chairman, loans to the lesser developed countries run into the hundreds of billions of dollars. Most of the economies of these countries are in poor shape. How realistic is it to think that a program such as the IMF has, with $40 billion of additional capital, is going to allow those debts to be repaid? Isn't it more realistic to face the fact that some of those loans will have to be written off as a loss to the banks and others?

Mr. VOLCKER. No, I don't think so, for the major borrowers we are talking about. The IMF programs and approaches and resources in and of themselves, are not going to lead to those debts being paid off; that is not the purpose of the IMF resources and the IMF lending. What will enable those loans to be moderated, if not paid off, by and large, is to have the debtors growing into a strong creditworthy position; they don't have to pay off all their debts. You want to have a climate in which those countries are so evidently creditworthy that they can finance themselves in the market, not one in which they will get themselves in difficulties in the future. You want to return to a more normal market climate with a debt burden that they can readily service. That gets you into questions, over time, of the growth of the world economy, on the one side, and their own policies on the other side.

Senator PROXMIRE. It's a matter of timing, too, isn't it? If you don't get some kind of recovery in the next 3 or 4 years, you might have to at least write down some of these debts and take some loss.

Mr. VOLCKER. If you project a pessimistic world economic scene, then you imply an enormously difficult problem.

Senator PROXMIRE. Well, the OECD estimates of growth on the world scene is 1 percent growth in the next year.

Mr. VOLCKER. Growth estimates are sluggish for the next year, but I don't think that in itself means we can't work out of these problems. I don't think that at all.

Senator PROXMIRE. I'm just suggesting one way to work out of it is to face the fact that you may have to take these losses.

Mr. VOLCKER. There is always an ultimate risk, but we are talking, in these major cases, of countries that have very great resources and have themselves attached very high priority to servicing these debts. I think objective analysis can demonstrate that those debts can be manageable over a period of time. They do need time, there's no question about that, and they need to adjust themselves. The debts are not manageable at the rate of speed that they had been mounting.

Every one of those countries has embarked upon a very strong, euphemistically called, "adjustment program." And it is those programs—which will be greatly facilitated by growth in the world economy—that are going to restore their access to markets in a freer way and enable them to proceed without a further buildup of their debt or with only a modest buildup of the debt. You can see those ratios of loan exposure to banks' capital improve, and you can see the ratios of debt service to exports, to GNP—however you want to measure it—improve as well. It's the aim of all these programs, and I think it's preeminently possible and probable.

Senator PROXMIRE. Has there been any projections as to how and when these debts could be paid back in a likely and orderly way?

Mr. VOLCKER. We don't have any projections that go out through the years as to how Mexico would repay $80 billion worth of debt, or how Brazil would repay $80 billion worth of debt. We have projections that we think are consistent with our own programs, and reasonable assumptions about the world economy——

Senator PROXMIRE. Will you make those available to the committee for the record?

Mr. VOLCKER. To the extent that I can—in the short term, I was about to add, the next year or two.

[The following information was subsequently submitted for the record:]

Prospects for Debt Repayment, Commitments to Balance of Payments Adjustment, and Projections of Debt Burdens--Selected Latin American Borrowers

For a transitional period, major Latin American borrowers are likely to require an increase in their outstanding indebtedness to foreign banks. In all cases, the overall external debt of these countries is expected to grow by less than ten percent annually in 1983 and 1984. However, within this period, each of the major borrowing countries can be expected to restore orderly, unrestricted payment of debt service to their foreign creditors on a loan-by-loan basis.

Brazil experienced a current account deficit of about $14-1/2 billion in 1982. Brazil has embarked on an IMF-approved program which is designed to reduce that deficit to $7 billion in 1983 and $5 billion in 1984. As a result, requirements for new foreign borrowing will fall to much lower levels, and Brazil's external debt will grow less than half as rapidly as the projected value of its exports. Taking account of declines in world interest rates that have already occurred, Brazil's debt service ratio (scheduled amortization requirements on medium- and long-term external debt plus total external interest payments divided by annual receipts from exports of goods and services and transfers) will fall from about .79 in 1982 to .62 in 1983 (which equals Brazil's average debt service ratio during 1978-81) and to a projected .55 in 1984.

Mexico's current account deficit fell from $13 billion in 1981 to about $6-1/2 billion in 1982. In accordance with its recently adopted stabilization program, the current account deficit was expected to decline to about $4 billion in 1983 and 1984. Mexico's reduced needs for financing the current account, in addition to policy measures to halt the large outward capital flight witnessed in 1980-82, should reduce the growth of external debt to about

6-8 percent annually during 1983 and 1984. Mexico's debt service ratio for 1982 is estimated to have been about .61, which was considerably higher than in 1980 or 1981 but lower than during the late 1970s. The projections underlying Mexico's IMF program imply debt service ratios of about .59 in 1983 and .50 in 1984.

Argentina's current account deficit fell from $4-1/2 billion in 1981 to $2-1/2 billion in 1982 and is projected to fall to $1 billion or less in 1983 and 1984. While Argentina faces additional near-term financing needs to pay off external arrears that have accumulated since April 1982, the massive capital flight of 1980-81 has subsided. Argentina's estimated debt service ratio rose sharply from about .50 in 1981 to about .95 in 1982. Because of a bunching of scheduled maturities in 1983, that ratio is likely to remain about .95 in 1983 but fall to about .60 in 1984.

Senator PROXMIRE. Now, according to Table V attached to your statement, the nine largest U.S. banks had 112.5 percent of their capital out in loans to Argentina, Brazil, and Mexico: 19.6 percent to Argentina, 43.5 percent to Brazil, and 49.4 percent to Mexico.

What would be a reasonable percentage to each of these countries?

Mr. VOLCKER. That is so difficult to judge, and it's a question you get into when you talk about an arbitrary limit on these loans. You will notice on that table that the Brazilian exposure is about the same in 1982 as it was in 1977. Now, it may have been too much in 1977, but it is clear from that kind of measure that what has changed is other conditions—not the relative exposure—in that 5-year period. That is not true of Argentina.

Senator PROXMIRE. Other conditions might make the situation sound in 1 year but not sound in later years.

Mr. VOLCKER. Yes, and the growth of the economy, the trend of its own payments position, external markets, raw materials developments. Obviously, if one thinks in terms of a lending limit—and I'm not suggesting that—one has to think of limits that are not just good in fair weather but also in rainy weather. We've been having rainy weather recently in these countries. What looks good 1 year may not look so good another year, and if you're going to put in that kind of limit you have to think of both situations.

FOREIGN COUNTRIES PLACED IN FINANCIAL CATEGORIES

Senator PROXMIRE. I noticed that foreign countries are placed into three categories based on their overall financial situation: weak, moderately strong, and strong. Can you tell us if Mexico, Brazil, and Argentina were ever classified weak under this system and, if so, when they were so classified?

Mr. VOLCKER. Let me just say the word "classified" here ordinarily has a different meaning; it's used in banking examination across the board for loss, doubtful or substandard loans.

Senator PROXMIRE. You pick the term; anything you want.

Mr. VOLCKER. It's a good enough term. I just want to avoid confusion with the use of the term "classified" in banking examination, which has a very definite meaning. This is a relative meaning, and I am informed that Brazil and Mexico were in the lower of those groups.

Senator PROXMIRE. Can you tell us when? I'm talking about "weak."

Mr. VOLCKER. Brazil for several years, Mexico more recently, and Argentina around the time of the great conflagration in the South Atlantic.

Senator PROXMIRE. How recently with Mexico? Still?

Mr. VOLCKER. Within the past year.

Senator PROXMIRE. Still classified as weak?

Mr. VOLCKER. Well, you would expect that now.

Senator PROXMIRE. Was this communicated to the banks?

Mr. VOLCKER. It's communicated to the banks in the sense that it affects the kinds of comments made in their examination report.

Senator PROXMIRE. Well, in your judgment—that's why I made that reference to Rex Harrison when I started out. My time is up, but let me just ask this question related to that.

Mr. VOLCKER. I understand your quotation from Rex Harrison. That's one of the things that would concern us.

Senator PROXMIRE. And that's why I follow up by saying, despite the fact that the country classifications developed are confidential, they know it, but the banks don't seem to pay any attention to it. That is confirmed in the GAO study.

Mr. VOLCKER. I don't think that is completely——

Senator PROXMIRE. Why is your regulation so ineffectual in moderating it on behalf of the banks?

Mr. VOLCKER. I'm not sure that is completely fair, but let's stipulate that none of us has perfect foresight in these things. The difficult problem is that something might look good 1 year that won't look so good the next year. Not everybody, including the regulators, is very good at forecasting that. That is the nature of the beast.

Senator PROXMIRE. For Mexico, in June 1980 it was 31.7 percent of capital, and 37.9 in December; 40.8 in June, 44.4 in December; 49.4 in June. And the steady increase, very big increase, occurred after they were classified as weak.

Mr. VOLCKER. There is no question there has been a big burst in lending to Mexico through 1980 and 1981 and running into 1982.

Senator HEINZ. Senator Hecht.

Senator HECHT. Senator, I'm not on your subcommittee so I will relinquish my time to all the committee members.

Senator HEINZ. Very well. I would state, though, that all members of the committee have been invited to this hearing.

Senator Sasser.

STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

Chairman Volcker, I am delighted to see you again this morning and always like to hear from you in these hearings.

I was reading the Washington Post a couple of days ago, and you may have read the column, written by a distinguished columnist, and in that column he quoted Mr. Walter Wriston, the chairman, I suppose, of Citicorp., and Mr. Wriston was concerned that you weren't going to stay the course on our limiting domestic money supply and he was afraid you were going to go along and increase the money supply in an effort to bring interest rates down, and this was going to cause inflation.

It occurred to me listening to you testify this morning, and learning that Mr. Wriston's bank has loaned over 100 percent of their capital to one country, that we could certainly give him a taste of deflation just by not going along with the request to put an additional $8 or $9 million—billion; I am corrected—into these International Monetary Funds and other efforts to prop up the international system.

It troubles me with regard to testimony presented here today that our country appears to be an economic loser, whether we increase the IMF resources or not. If we don't support the IMF and a larger debtor nation defaults, of course, our exports are going to be jeopardized. If we increase the IMF support and the loans are made to a debtor country, these loans are generally made with the stipulation that the fiscal imbalances of the debtor country have to be resolved, and they have to get into a period of great economic austerity. I don't know how we are going to enforce that because we have great difficulty enforcing it on ourselves in an effort to do something about our budgetary problems. But part of that great austerity is they've got to limit their imports, and this is going to mean, I would guess, a rather severe limitation on U.S. imports——

Mr. VOLCKER. Exports.

Senator SASSER [continuing]. Exports to these financially troubled nations at a time when we are attempting to get our own economy going.

This is a fair analysis that we do find ourselves in an economic dilemma in this situation; isn't that correct?

Mr. VOLCKER. I would look at it differently. I don't think we are in a no-win situation, broadly interpreted. First of all, you asked where was the enforcer; the need for external credit is a pretty potent enforcer, and that leads me to the answer to the second part of your question.

There is no question that the austerity programs in these countries will reduce their imports. We have already felt that to a very major extent in the case of Mexico. The old question, "Compared to what?" arises. And I don't think there is any question that an orderly—as orderly as it can be—adjustment program, carefully thought out with the IMF, accompanied by some moderate additional support in external credit from the IMF, from the banking system, or from other governments, is going to lead to a less severe and more constructive adjustment in those countries and to earlier resumption of growth than if you simply cut them off; in that case you have net paybacks, and you have an even sharper impact on our exports.

Senator SASSER. Well, I think that may very well be true, Mr. Chairman, but I suppose my problem with it is this: We see that our banks have lent about 113 percent of their capital to foreign countries, according to the information that the committee has furnished me, and we feel here now, or are being told—and I don't find fault with you for saying this at all—that we need to come to the aid of the IMF and the IMF can come to the aid of these countries so that these loans from our large banks can be paid and we are in essence helping these less developed countries.

OBLIGATION TO SOLVE OUR TROUBLED ECONOMY

I suppose my problem is: Don't we have an obligation to help these financially troubled sectors of our economy? You and I have talked about this many, many times before. But don't we have an equal obligation here at home to try to get our financial house in order, to try to get our interest rates down domestically?

Mr. VOLCKER. Yes.

Senator SASSER. To help our people here. And how are we going to go out in the country and tell our constituents that we are going to use taxpayers' funds, $8 or $9 billion, to put it into these International Monetary Funds and other agencies in an effort to keep the large banks whole but we can't really do much for them.

I had a bank fail down in my State, as you well know, and you are very familiar with the circumstances on that, and there was much made of the fact that 23 percent of this bank's operating capital was loaned to one individual. Yet, we find here today that over 100 percent of Citicorp's capital is loaned to one country, Brazil. And I have a hunch that this bank that failed down in my State had a lot more control over this one individual that they loaned 23 percent of their capital to than Citicorp does over the country of Brazil.

So we've got not just a serious economic problem here, a serious international economic problem, we've got a serious domestic political problem, I think, in trying to explain it to our people here.

Mr. VOLCKER. I recognize that. Of course, I strongly think it is in the public interest, for all the reasons that I and others have cited. But let's take the example of your bank in Tennessee. An apparatus of Government support was brought to bear on that situation. Depositors in that bank didn't lose anything, and the continuity of the banking service in Tennessee was maintained. That's the kind of apparatus we have domestically.

The IMF is not a new institution. It was set up under the leadership of the United States, and clearly in our own interests as well as in the world's interest, at the end of World War II. This is not the first time its resources will have been replenished. It will be a continuing process in the growth of the world economy, if that institution is going to fulfill the functions that were laid out at the start. It's very much in our interest. We are in a particular situation where the pressures are particularly heavy and the institution exists to deal with situations of this sort. It has to be adequately equipped to do its job, and that requires more resources over the years, and it requires more resources particularly now when we have a really unprecedented situation arising in the international financial area.

But I think there is a general feeling in the United States—very strong in other countries, developed countries as well as developing countries—that this institution has a vital role to play. It is being challenged now by external circumstances. It has moved very aggressively in the interest of the world economy and our economy, but it needs the tools to do the job, and only the Government can provide that.

Senator SASSER. I think we can agree that the banks that made these very large loans to these developing countries were guilty of at least an indiscretion and not following the soundest banking practices. Do you agree with that?

Mr. VOLCKER. I wouldn't choose those words to characterize it at all.

Senator SASSER. Well, would you agree that perhaps the bankers down in Tennessee when they were loaning out large chunks of their operating capital, the accusation was made by some of the Federal agencies that they weren't following proper banking practices. Now, you said a moment ago that everything in this world is relative, and I suppose it is, but do we have a different standard of conduct for domestic bankers and international bankers?

Mr. VOLCKER. No, we do not.

Senator SASSER. My stockholders in that bank in Knoxville lost everything they had.

Mr. VOLCKER. That is true.

Senator SASSER. The depositors were kept whole. Now, what is going to happen to the stockholders of Citicorp and Chase Manhattan, J. P. Morgan, First National Bank of Chicago, Continental of Chicago, Chemical Bank, Manufacturers, Hanovers Trust, Marine Midland? Are they going to suffer any loss as a result of these loans which on the surface to me—admittedly I don't know a lot about the banking business—don't look very sound, frankly.

Mr. VOLCKER. I'm not a bank stock analyst, but I know I've heard on a number of occasions over recent years, when the stocks of many of these banks have been trading well below book value or with relatively high yields, that one important factor in their lack of popularity among many potential and actual shareholders was a certain amount of concern over their exposure abroad. The marketplace makes its own judgment about those factors. Whether that judgment is justified or not, time will tell, but I think it is reflected in the price of their stocks.

Senator SASSER. Thank you, Mr. Chairman.

Senator HEINZ. Senator Lautenberg.

STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thank you, Mr. Chairman.

The theme that seems to thread throughout our discussion, Mr. Volcker, is one of the behavior of the very sophisticated banks in the way they apportion their loan reserves or their loan opportunities. Some earlier questioning dealt with the kind of barometers or yardsticks that might be used in classifying these loans or risks. It looks like a scale of something like A through G, starting with "avarice" and winding up with "gluttony."

What we see is a violation, I think it's fair to say, of good practice in terms of the way these loans were made. Now the question is who pays the piper. I think Senator Sasser was referring precisely to that. And though we may be locked in, I think it's fair to say, to these commitments, certainly we have to protect our financial system against such future activities.

Would it be logical at this point, instead of continuing to capitalize these errors, to perhaps recast these loans, extend the payment terms and reduce the interest rates—instead of going through these adjustments by additional loans? If it's possible, ask the banks who have made loans to the private sectors in these countries—and I guess there are some sovereign loans, though I don't know and I'd be interested in knowing if that is correct—perhaps to take their interest income in a reduction of capital as opposed to adding to their operating income; this was suggested in the testimony of Mr. Mayer a couple of days ago.

The fact is that the penalty has not been seen in some of the bank-share prizes. Banks continue to make aggressive investments in nondirect banking areas, looking for diversion when I think their primary function is to provide capital. And I think what is happening is that our citizens are being asked to take the pain much more directly than are the financial institutions with all their professional skill and all their sophistication.

Mr. VOLCKER. I don't think our citizens will feel any pain if we are successful in this venture. Where they feel the pain is if the situation is not managed. That is the risk in this situation, and that is the overwhelming risk to which we must direct ourselves.

The possibility you referred to of how to use interest income is a fair question. These are the kinds of things that are under review. I would say I don't think it's appropriate to take this particular action in the case of some of these major countries that have been servicing their interest steadily and have displayed a willingness to undertake very forceful adjustment programs at home, and have a logical program for working themselves out of this problem. There are countries that have essentially been in default for some years, where that kind of suggestion is quite appropriate, and I think many banks follow that practice now.

COUNTRIES IN DEFAULT FOR YEARS

Senator LAUTENBERG. It was interesting that you said that countries have been in default for years. When I had the opportunity to hear some people from the Department of the Treasury make a presentation, they said no borrower had been in default. And when I asked if there were countries that were delinquent, they also responded negatively and said that we continue to adjust these programs. I guess that's a privilege reserved for nations and not individuals.

Mr. VOLCKER. The countries I am referring to are rather small countries, but they are in default.

Senator LAUTENBERG. They are clearly in default.

Mr. VOLCKER. They are delinquent, anyway.

Senator LAUTENBERG. They are delinquent to the point of defaulting, except the axe has not come down.

Thank you very much, Mr. Chairman.

Senator HEINZ. Thank you, Senator Lautenberg.

Senator Hecht.

Senator HECHT. Mr. Volcker, what responsibility or liability do you see for directors of these banks?

Mr. VOLCKER. The directors of the banks clearly have the responsibility for overseeing the general policies of the bank with respect to foreign loans.

Senator HECHT. As Senator Sasser said, you see no distinction, then, between domestic and foreign lending banks, the same set of standards?

Mr. VOLCKER. Yes. Obviously the nature of the lending creates some differences, but as a general approach there shouldn't be any distinction.

Senator HECHT. Have you been in contact with directors of these banks while these loans were classified?

Mr. VOLCKER. These loans are not classified in the normal sense of the bank examination process. Some of them may be classified in that sense, too, but that's not what Senator Proxmire was talking about. Have I directly been in contact with directors of the banks? Not in any organized way. We work through an examination process, where the examiners present an examination report. Sometimes they do that personally to the directors.

Senator HECHT. Well, domestic banks—as the FDIC makes their examination, then they classify the different loans down the line. Have the directors responded to any of these different reviews?

Mr. VOLCKER. I can't tell you in any precise way how they have reacted. I don't know how you would measure that in any direct way. But the normal practice is that an examination will be completed, and the results of that examination—including the foreign and the domestic parts, which are all part of the same examination—are presented to the board of directors. Sometimes it's presented personally; sometimes it's presented in a letter. With larger banks, I think it's often done personally, maybe always in the case of some institutions.

Senator HECHT. Because the directors also have that situation that they are guilty of acts of omission so it's their responsibility to know that a bank has such——

Mr. VOLCKER. Oh, yes. A major purpose of the examination process as it encompasses foreign lending is to bring this concern—concern in the broader sense—to the attention of the directors so they are conscious of the need to set limits; they are conscious of a need to make sure that their bank is evaluating limits. That doesn't give you an answer as to what the limits should be. That is a matter of very difficult judgment. But it certainly should be a conscious decision, and it should be a matter the directors are concerned with, both with what the limits may be, and with some of the procedures within that bank for evaluating this situation.

Senator HECHT. Now, there is a term we use in banking, "prudent banking practice." It is kind of inconceivable to see how they can have such loans in the amounts——

Mr. VOLCKER. It may look that way now. We all have the great benefit of hindsight. But even with hindsight, international lending in its broadest sense, I think, has played a constructive role in the development of the world economy, in our interest and the interest of American workers and businesses. It is a question of proportion, and that is a very hard thing to judge. What looks reasonable in fair weather looks less reasonable in your eyes and in the eyes of others now. You are coming down to a question of judgment.

Senator HECHT. Thank you. No further questions.

Senator HEINZ. Thank you, Senator Hecht.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Mr. Chairman, your testimony identified five general things that have to be done for what you have identified as the worst financial crisis in the postwar period. I don't know whether that was hyperbole.

Mr. VOLCKER. I said, "an unprecedented threat," and that's what I meant. I didn't say it was the worst banking crisis, but a threat to the financial system we haven't had to deal with during the postwar period.

Senator DODD. My point is this: I went down your list here, and in addition I happen to believe and will support the Administration's request for the additional authority for the IMF. I think there is no other choice under the circumstances. But that to me is the least of the problems. The two most significant questions, as far as I'm concerned, are your point one and point five in the list of five that you identified. That is, the ability of the nations who are suffering this severe problem to adopt austerity programs that have been framed by the IMF; and fifth, their ability to reduce the deficits in their balance of trade, whether they can do that under the present international economic circumstances.

FED'S ANALYSIS OF BRAZIL, MEXICO, AND ARGENTINA

I'd like you to give me, if you could, your assessment, since you have identified rather extensively the particular circumstances of Brazil, Mexico, and Argentina. What is the Fed's analysis of Mexico and Brazil and Argentina's ability to do one and five on the list of five things that you claim have to be done if this program is to be successful?

Mr. VOLCKER. Let me say I think you correctly identified one and five as the economic fundamentals. The other part is financial engineering. That is important, but in some sense perhaps less fundamental.

Obviously I am reluctant to discuss in detail these particular countries, but let me say each of them has embarked in good faith on a very strong adjustment program. All three of those countries have great strengths in their economies in different ways, demonstrating at times in the past and recently for two of those countries—"recently" meaning the last decade—great growth potential in different ways. Mexico has great oil resources. Brazil is a big oil importer. But they have made great strides in building their industries, in building their infrastructure. I think it's easy to say in retrospect—and not so difficult to say when it is going on—that they were expanding a little fast and in ways that were unsustainable considering they generated these kinds of external deficits and external financing in the proportions that were generated.

But do those countries have the basic strengths to make these adjustments to be competitive in world markets in their different ways—oil in Mexico, agriculture in Argentina, industrial strength in Brazil? I think I would give you an unqualified answer that yes, they have that potential.

Senator DODD. Let me ask you this: What are your estimates or what would you think will happen to oil prices in the next six months? Where do you think they will be?

Mr. VOLCKER. You get a quite different impact from declining oil prices on each of these three countries.

Senator DODD. That's why I asked the question, obviously.

Mr. VOLCKER. It covers the spectrum beautifully. As I understand, in Argentina that won't have much effect externally. Brazil is one of the larger importers of oil. Mexico is one of the larger exporters.

Senator DODD. Right, hence the question.

Mr. VOLCKER. Brazil's adjustment or external borrowing problem will be eased. Mexico's will be increased. There is a potential offset there, if I may suggest. I testified all morning yesterday on monetary policy, on the importance of inflation coming down and staying down in connection with the outlook for interest rates. Obviously, if the oil price goes down, the inflation outlook here and elsewhere will be improved; that is a favorable climate for interest rates going down further. And because these countries are so heavily indebted abroad, they benefit on the interest rate side if that is the result of that economic climate.

Senator DODD. I want to focus on Mexico. We have a 2,000-mile border with them. I just spent 10 days in Mexico and Brazil on this very question, their ability to adopt these austerity programs, whether or not labor and the political party in Mexico are going to go along with it, what potential Brazil has with their program. And obviously a decreasing oil price internationally is going to make Mexico's situation far more difficult. Their answer to what they are going to do in terms of expanding industrial capacity is tourism and cotton. If you are going to come up with $85 billion in tourism and cotton, I'd like to know how you are going to do it. Oil prices are going to have a profound effect. What do you think is going to happen to the price of oil in Mexico?

Mr. VOLCKER. You're asking me for a forecast of oil prices?

Senator DODD. Yes, that was the question.

Mr. VOLCKER. I think I'm going to withdraw at this point. I think there are obviously pressures on the oil price, and there have been declines in the effective price of oil. I would not be surprised to see further declines, but trying to quantify that is not in my area of competence.

Senator DODD. But you see further decline in prices?

Mr. VOLCKER. I think, certainly in real terms, in the foreseeable future; and there could be declines in nominal terms. But the significance of that for Mexico is directly related to the question of proportions where I can't make a judgment.

I must say I asked that question of my friends who are much more expert than I about oil prices, and they gave me the same answer that I gave you.

Senator DODD. That is it's going to decline but they won't say——

Mr. VOLCKER. They think there is downward pressure, but they are very uncertain about what the amount might be.

Senator DODD. We don't have much time, but what we haven't discussed—we have generally been talking about sovereign loans here. I think everybody assumes that is all we are really talking about and, of course, there are a great deal of debt obligations, of course, to private companies in these countries. What we are talking about, of course, is an answer you have identified, and what was being suggested by some legislation offered by the Senator from Pennsylvania and the Senator from Wisconsin deals primarily with the sovereign loan issue, I suspect. Is that correct?

Senator PROXMIRE. It would include both loans to individual firms within a country and sovereign.

Senator DODD. I apologize.

Since it's much more difficult to deal with the private loan than the sovereign loan, do you have any suggestions on what might be done to require banks to be more judicious in the private loan category, or would you make any distinction?

DISTINCTION BETWEEN SOVEREIGN AND PRIVATE LOANS

Mr. VOLCKER. I do make a distinction in my mind, but maybe an opposite distinction than you're making. I think possibly one of the difficulties, from a supervisory standpoint, even from a banking standpoint, is that there is a certain natural discipline in lending to a private borrower. The banker knows the private borrower. It's a familiar kind of problem for the bank. Can that particular borrower repay a loan? Is it engaged in constructive investment? Is it going to have the revenues, in its own currency, to service the loan? That puts a discipline on the lending, a normal market discipline on the lending.

They have to worry about the prospects for that particular borrower.

The sovereign loan is of a different kind. You've got a different kind of credit judgment. You're talking about the capacity of the whole country. There is no market test in the same way. From the supervisory standpoint, I think the problem is, in a sense, focused more on the sovereign loan than on the private loan simply because that market discipline is either absent or is not present in the same way. I think when one looks back at this and sees this enormous growth in loans, one wonders whether the problem isn't partly related to the practice of making sovereign loans which practically didn't exist 15 years ago. It grew up very rapidly after the oil crisis. Maybe a useful discipline can be exerted in an opposite sense than what you may have been suggesting—that the principal supervisory problem lies in the sovereign loan area where a certain market discipline was absent.

Senator DODD. That's what I was suggesting.

With regard to that distinction between the sovereign and private loan, it seemed to me—and correct me if I'm wrong in this but again I'll refer to the legislation that Senators Proxmire and Heinz have suggested where the Fed would play a more significant role—the Fed would be setting loan limits on a country by country basis and so forth, helping to try and play a greater role in assisting lending institutions and making decisions about whether or not they ought to commit resources.

It seemed to me that maybe a better institution, although it's obviously subject to some severe critcism these days, is the IMF rather than the Fed. I'd like you to comment on this because we're talking about substantial loans being made by other banks outside the United States and to the extent there is a greater ability to determine exactly what is happening in these countries from numerous other sources, it seems to me to make a bit more sense, but I'd like you to comment on that.

Mr. VOLCKER. You certainly put your finger on a major problem, that international banking problems are international by their nature, and we can't cure them by action in the United States. You can limit the participation of our banks, obviously, but there are strong competitive pressures working in the other direction if other banks are free, so to speak.

I never thought, frankly, of the IMF putting on legal lending limits in effect around the world.

Senator DODD. I wasn't suggesting that. I was thinking of something as simple as the idea that if you're going to lend a certain amount of money to "X" country that you would have to submit that to the IMF not for veto necessarily but at least there's some coordination.

Mr. VOLCKER. In concept, that may not be such a bad idea. But let me say the IMF in some instances has moved in a direction that I think is very much related to the point that you have made. We forget now that we are in a situation where these loans have been called into question. Very few years ago the climate was quite different; everybody wanted to make these loans. The IMF occasionally had a problem and perceived they had a problem—I think in fact they did have a problem—when they would enter into a stabilization agreement with a country and they would become somewhat concerned that the country would be overfinanced, with the result that the pressure on the country to conform to the adjustment program would be relieved and the purposes of the programs would not be achieved. The IMF would want to put a limit on the amount that the countries could borrow because everybody was very eager to lend to them.

Now they've got the opposite problem. For the adjustment program to succeed they need the financing and they have become increasingly active in both directions and basically there is a logic in that.

Senator DODD. I'd like to see you make that same argument in domestic spending from time to time.

Mr. VOLCKER. In the IMF program they go about it pretty aggressively. I would just comment that the IMF activity has been limited to cases where the countries have an adjustment program. By way of making a constructive suggestion, when one looks at the international financial problems, the question is how does one get the Fund into the act sooner? You don't go right to the brink. We are going right to the brink with all these countries. We would have been much better off, obviously, if these adjustment programs had started in these countries that we're dealing with a year ago or 2 years ago. The adjustment programs could have been much simpler. They wouldn't have had the same problem in financing the adjustment programs if they had brought them about earlier. But countries are very reluctant to go to the IMF until they are at the brink. If we could create some incentives in the system so that we attack these problems at an earlier date, then we would have really done something. I think we ought to look at all these supervisory proposals in that sense.

Senator DODD. Thank you.

Senator HEINZ. Senator Gorton.

Senator GORTON. Mr. Volcker, I think we are faced with a set of policy options that present something of a paradox on which I'd like your comment. We are asked to provide a substantial infusion of new capital to the IMF and I must say I find your arguments in favor of that very, very difficult to debate.

At the same time, the IMF will use that money as leverage to persuade a number of the recipients of loans from it to reduce quite substantially their imports which, in turn, one presumes will harm economic recovery in the United States which supplies most of those imports.

THE BEST OF THE BAD JOB

Is this simply an inevitable consequence, the best of a bad job? Is this something we should think of in connection with that process?

Mr. VOLCKER. I would accept your comment that it's the best of a bad job. I would rather put it more positively that the consequence of not doing it—I don't know whether this is more positive or not—is much more damaging, because if these countries get no external credit, get no assistance from the IMF, they are going to have to adjust even more abruptly, more precipitously, and in a way that gives much less promise of an early restoration of their growth.

Senator GORTON. Or of ours?

Mr. VOLCKER. Therefore, indirectly, of ours. There's no doubt at all in my mind that this is in our best interest, although you're quite right that just viewed at in comparison with the last few years their imports will be going down.

Senator GORTON. And it is absolutely necessary that they pass through that regimen?

Mr. VOLCKER. I see no alternative.

Senator GORTON. Just in one of your incidental comments and one of Senator Dodd's, you triggered my next question. We are looking at a financial situation in several of these foreign nations which is very, very serious and is compounded of a significant trade imbalance, an overwhelming trade imbalance in some respects, great imbalances in their own internal budgets, and I suppose one must always say, at least in comparison with the dollar, a high internal inflation. It seems to me that may be a pretty good description of a lot of what's going on in the United States as well.

Would your prescription for the United States be similar to the prescription which the IMF is going to impose on these other countries? Is there some absolute divine guarantee that the United States of America can't run into this kind of problem?

Mr. VOLCKER. There is none at all. We have, in fact, borrowed from the IMF in the past when we had great pressure on the dollar. We have never borrowed the amount that would require us to have an IMF adjustment program. Only when you have to borrow a large amount of money relative to your quota do you have to consult with the IMF and agree with them on an adjustment program. We have never been close to that point, but we have borrowed from the IMF.

Senator GORTON. Is your own prescription for our domestic economy different from that of the IMF for these borrowing countries?

Mr. VOLCKER. The matter of degree is enormously different, but I suppose in some sense it is a matter of degree. I said we don't have to go through the same adjustment process. We have just been through a recession; I hope we are coming into a recovery now and we can reap the benefits of the disinflationary process that we've been going through.

Senator GORTON. But it's that kind of disinflation process these other countries must go through?

Mr. VOLCKER. Yes, and specifically in budgetary terms. I do a lot of talking, and other people do a lot of talking, about our budgetary problem. At the heart of all of these IMF adjustment programs in these particular cases is getting the government's demand on the resources in these countries down, so they are not sucking in resources from the rest of the world basically to finance government deficits.

That problem is in some broad sense very similar, except that in Mexico's case the government deficit last year ran 16 to 17 percent of the GNP. They have proposed and the Fund has agreed that cutting that deficit in half in a year is part of that adjustment program. Similarly, the deficits are not quite as big in Brazil and Argentina, but they have been the same order of magnitude and they are being asked to make adjustments in the same order of magnitude. That is the same direction we'd like to see the United States go. They make our problems look like a rose garden, but there's perhaps a lesson there.

Senator GORTON. Thank you. On an unrelated subject, a great deal has been made of the fact that our major banks have lent an amount equal to their entire capital stock to one or more foreign countries or to other creditors in those foreign countries.

Isn't it true that since bank capital is such a small part of total assets that many banks have also lent amounts of money equal to their capital to say agricultural loans within the United States or the computer industry or the like?

Mr. VOLCKER. Yes, certainly, if you took the whole industry. They wouldn't do it in an individual country, and I think these figures very much have to be kept in some sense of proportion. That is, in retrospect these ratios always look high for some of these countries or have for some years, but it's very hard to determine just what an appropriate ratio is.

Senator GORTON. Thank you, Mr. Chairman.

Senator HEINZ. Thank you, Senator Gorton. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Did I understand you to say earlier in response to Senator Sasser that if we do not increase IMF support, that we could really see chaos? That's a word you used and I'm just wondering if that's the context in which you used it.

Mr. VOLCKER. "Chaos?" My recollection is that I used it in relation to the conditions in those countries if they had external credit shut off.

Senator RIEGLE. Well, let me ask you the question a little differently then. If we did not approve this package, how destabilizing an event would that be? How close to "chaos" are we?

Mr. VOLCKER. It's terribly difficult to judge. Somebody asked me that question in the House hearing the other day and essentially I said I can't tell for sure. I know it would remove one more element of protection that makes the whole situation riskier. It could be very difficult. But I said I couldn't tell; if this thing goes very smoothly, maybe they will never need these additional resources. I got criticized afterwards for not making a strong enough case; I was told, "You should say that things would go to hell so that the Congress passes it." I don't want to be irresponsible about it. I want to give you my best judgment.

Senator RIEGLE. I understand and appreciate that and you have answered my question. I want to discuss Mexico later, but let's move through some other matters first.

LARGE UPFRONT FEES ON FOREIGN LOANS

Don't the U.S. banks that make these large loans abroad get large upfront fees on these loans?

Mr. VOLCKER. Yes.

Senator RIEGLE. And those fees, don't they show up in bank earnings, which are presumably the basis on which salaries are paid?

Mr. VOLCKER. My understanding is that the accounting rules are a little hazy but they make a distinction between fees to cover expenses, fees that are in the nature of a syndication fee and a fee that is essentially a substitute for interest; if it's the latter, it is spread out over the life of the loan.

I also have the impression that those rules are fuzzy enough so that there's a certain degree of flexibility on the part of the banks as to what they do, and I think individual banks probably differ. To get to the point, I would accept the proposition that if the frontend fees are artificially taken into current earnings, that probably isn't a good banking practice.

Senator RIEGLE. Well, I would hope we could change that practice and I think that it's clear that there is a higher rate of profitability on these loans. That's why these loans have been made in other countries rather than our own.

Mr. VOLCKER. Partly profitability. I think there was a certain amount of fashion involved. We have often commented frankly in the past—I speak of myself and other governors—about how low the interest rate margins were on many of these loans in earlier years when everybody was feeling very confident.

Many of the loans had pretty good front end fees but we wondered whether the interest rate itself was high enough to reflect the risk and the need for capital to support loans.

Senator RIEGLE. That's why the fees may have a more direct bearing on it, but there may be other things that impact the measure of the profitability apart from the interest rate itself.

LIST OF FOREIGN GOVERNMENT AND PRIVATE LOANS

Does the Fed have a list of all the foreign government loans and the foreign private loans made by banks here in the United States? Do you have that list?

Mr. VOLCKER. Individual loans?

Senator RIEGLE. Yes. In other words, could you provide us right now, for example, with a list of all the loans major U.S. banks have made to Mexico, both to the government of Mexico and the private borrowers?

Mr. VOLCKER. Yes; we can provide those.

Senator RIEGLE. OK. I think we ought to have those and I'd like to request that we get them.

Mr. VOLCKER. They may be in my testimony before the House.

Senator RIEGLE. I would just ask that we have them. I think whatever detail you have that builds up to those aggregates would also be useful for us to be aware of.

Mr. VOLCKER. We don't provide them by individual banks, but we do provide aggregate numbers.

Senator RIEGLE. That's what I'm asking for. I'd like to see it by individual bank. You must accumulate it some way.

Mr. VOLCKER. Yes; we have a very good reporting system here. It may not be very fast, but we have a very elaborate reporting system.

Senator RIEGLE. Would there be any problem with providing that to the committee?

Mr. VOLCKER. For individual banks, yes.

Senator RIEGLE. What's the problem?

Mr. VOLCKER. The problem is that we protect the confidentiality of this information; we get it on the understanding that it's confidential.

Senator RIEGLE. Then I ask that we get it on the understanding that it is confidential and what I'm asking is the degree to which each individual bank has an aggregate amount of outstanding loans by country.

Mr. VOLCKER. We have not given information by individual countries. We have not given it by individual banks. We give it by limited groups of banks. The standard practice we agreed upon with the Congress some years ago was to go by the figures for the nine largest banks taken together, so you get an idea of what the nine biggest lenders are doing.

Senator RIEGLE. I'm not sure that's enough. Given the fact that we have a serious problem here and are being asked to act in some haste on it. I think we can talk it over with the chairman, but it would be my hope that we could get an aggregate figure broken down by U.S. banks and by foreign country without identifying specific private loans to individual customers.

Mr. VOLCKER. Maybe you can avoid the disclosure on the private loans, but if it's a single bank lending to the Government and you have disclosed its position, which is competitive, generally in the bank supervisory process we resist disclosing this kind of information on an individual bank in detail.

Senator RIEGLE. I think this is an extraordinary situation, however; in fact so much so that we are considering putting a new limitation here on the way these loans are made, and I support that. I think we do need a sharp limitation on these private bank loans that are being made abroad in the amounts that we've seen. Granted it's hindsight in terms of the problems that have developed, but we have to learn from hindsight and that's one of the things we have to do.

AUSTERITY MEASURES QUESTIONED

Let me move to another issue. Are these austerity measures that are to accompany additional lending to foreign countries going to work? As I understand it, about 40 percent of the money that we are going to put into these countries through the IMF will come back to the United States and roughly 60 percent will make its way out to other end uses either within the country or other parts of the world. I don't know if you have seen the movement in manufactured goods in the "Trade Account" over the last year and a half, but I'll give you a quick summary—and I think every member of the Committee will be interested in this because we all have varying degrees of manufacturing in our States.

In 1981 we were running roughly a $12 billion surplus in the manufactured goods account in the balance of payment. That began to reverse itself at breathtaking speed and continues to do so, which gets to the problem others have mentioned today. As these countries limit their imports from the United States and other places, it begins to cave in the balance of payments account here in the United States. It's turned so quickly that after running a positive balance of $12 billion on an annual basis in 1981, we were running at the rate of a billion a month deficit in October of last year. So we have had a significant multibillion-dollar swing in that account in just over 12 months. That's an exponential rate of change and it's so dramatic that it raises the question in my mind, given our own economy problems, whether we can afford to make major new foreign loans, the bulk of which will not benefit our economic and may, as a matter of fact, have the reverse effect.

The austerity programs that have to be imposed in these countries are to the effect that they have to clamp down very sharply and block out imports. So that's a catch-22 problem that relates to our own ability to get real recovery going here.

If, for example, this deficit in manufactured goods account continues to increase at this rate as these nations try to tighten down, it appears that we may be spending an enormous price here at home, a price that has not been clearly identified.

To bring it home even more sharply, Senator Dodd was talking about how Mexico hopes to not only block our imports but to increase their exports. As I understand it, we have been negotiating with Mexico for 3 or 4 weeks in a very intense way to extend them additional credit in a variety of forms in exchange for action they take to stablize their financial situation. And now there appears to be a very ominous stall in those proceedings because it may not be workable. I know you're nodding your head no. I hope there's hard evidence to support the fact that that apprehension is unfounded and this thing is coming together. But whether it is or isn't, in the case of Mexico—and I welcome your comments there—I think we need to have your comments on what's happening with respect to manufactured goods as this equation tips the other way and we end up financing a rising level of unemployment in that sector of our own economy by every dollar that we ship out of the country this way.

Mr. VOLCKER. On that point, let me say the premise of your remarks—on our declining trade balance and our declining manufactured goods balance and the depressing effect that has on our economy—is true. A major factor in the decline in our own GNP during this recession has been a decline in exports. I draw precisely the opposite implication from that situation for the IMF legislation and for this program, because it is through this kind of a program that we provide the best chance for less decline than otherwise in the short run and for sustained increase over a period of time as early as possible. That is in one sense, from our narrow perspective, the justification for the program, to speed and ease this process, to avoid it being further aggravated. It's already difficult. Our exports aren't going down just because of these particular problems, but the decline certainly added to by these problems; there's a $10 billion or so reduction in exports to Mexico already. I accept your premise; I agree with it; It's true. But the implications of this program are just the opposite of those you were drawing.

MEXICAN DEVELOPMENTS

Let me just make a couple remarks about the Mexican developments. The negotiations have been proceeding for months. Mexico is agreed on an IMF program and has been for some time. They have introduced adjustment measures for some months. My impression is that adjustment is proceeding very rapidly in that country, at great pain in the short run. That was known, that their external financial needs are being reduced. If anything, it's probably proceeding faster than we could have expected.

The one part of the program that has not been completed and has dragged out longer than I would like to see it—it's a very complicated negotiation among a thousand or so banks—is wrapping up in the final form the commercial bank part of the credit package. I expect that to be completed in a matter of days.

Senator RIEGLE. We have missed some deadlines on that, if I'm not mistaken.

Mr. VOLCKER. I expected it to be completed, originally, in January. It turned out to be more complicated, but I now look forward to it literally in a matter of days.

Senator RIEGLE. Well, my time is up, but I offer one additional comment for you to think about. And that is, we might be better off if we could find a way to extend these additional billion dollar chunks of credit, in the form of credit for American goods. As a matter of fact, if we in fact could ship items that we were producing rather than having to hope for a 40 percent return on the dollars we ship, I think we would be in better shape.

Mr. VOLCKER. I don't know where the estimate of the 40 percent return comes from. I haven't got estimates of that kind. I won't attempt to make one.

Senator RIEGLE. It came to this committee by an earlier witness.

Mr. VOLCKER. The U.S. Government is advancing some agricultural credits to Mexico. Nature was not kind to Mexico either last year, and it had poor crops, but we will be financing directly shipments of American exports of grain and, indeed, to some extent through the Export-Import Bank; that's part of this program.

Senator RIEGLE. That was Secretary Regan's estimate when he was here.

Mr. VOLCKER. I haven't seen those estimates. They are very complicated and difficult to make. In the case of Mexico—it would be different for every country—because Mexico is such a close trading partner of ours, our exports are likely to benefit from IMF assistance to a much greater extent than in some other countries. We only provide a fraction of what the IMF provides.

Our share of quotas is 19 or 20 percent—depending on whether before or after the increase, presuming there's going to be an increase—but just what currency countries draw, what currency they use at any particular time, depends upon circumstances in the marketplace with respect to that currency.

There is no pattern that's laid down for all times as to whether the Mexicans would, in effect, indirectly be borrowing dollars, marks, yen; presumably they would be borrowing some mixture in some proportion that's unknown at this point in time.

Senator RIEGLE. Thank you.

Senator HEINZ. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Yesterday when you were testifying before this committee you agreed that the IMF policy in relation to the LDC's to import less and export more was sort of on the protectionist side of policy.

Mr. VOLCKER. Was sort of a what policy?

Senator MATTINGLY. Protectionist.

PROTECTIONIST POLICY

Mr. VOLCKER. No.

Senator MATTINGLY. It's not?

Mr. VOLCKER. No. I think in our colloquy yesterday, I pointed out that a premise in entering into this kind of program is to encourage more open markets; that is basically in the Fund's charter, that they are there, among other purposes, to encourage open trading and payments arrangements. Typically, in these adjustment programs they look toward countries removing restrictions, not increasing them.

Senator MATTINGLY. But the IMF says to import less and export more.

Mr. VOLCKER. Through the reflection of general economic policy, not through trade restrictions.

Senator MATTINGLY. Well, that doesn't mean anything. What do you mean by general economic policies?

Mr. VOLCKER. It's not protectionist. They are not saying give preference to Mexican industry, to put controls on Mexican trade.

They are saying, "You have been living above your means; you have to cut back." But they are not saying adopt protectionist measures.

Senator MATTINGLY. In other words, that policy doesn't even have any impact on the industrialized countries?

Mr. VOLCKER. If they improve their trade balance somebody else in the world is going to have a worse trade balance. It's all got to add up to zero theoretically. It doesn't in fact; there's a big statistical discrepancy.

Senator MATTINGLY. That's right.

Mr. VOLCKER. We are all trading with the statistical discrepancy.

Senator MATTINGLY. But all the mumbo-jumbo of the IMF saying they want the countries to lower their imports it is going to have an impact on the industrial countries.

Mr. VOLCKER. That is right. It's just not protectionist.

Senator MATTINGLY. It's not protectionist. OK. What would we term that?

Mr. VOLCKER. We would term that an adjustment process.

Senator MATTINGLY. That sounds like the tax bill last year we used enhancement.

Mr. VOLCKER. No. Senator, for several years, up until 18 months ago, our trade balance was improving quite dramatically. That wasn't protectionist. We were improving our trade balance. We were getting more competitive.

Senator MATTINGLY. Do you believe the U.S. could use the tool of conditionality of loans to reduce trade restrictions like export subsidies and standard requirements which American exports face in international trade markets?

Mr. VOLCKER. I think that sometimes can be a lever. That's what the IMF does; the best way to do that is do it through a multilateral institution. If you've got an institution that can represent not just the United States, but the collective interests of the world, and it is putting that kind of pressure on a borrowing country, there's no better way to do it.

Senator MATTINGLY. What instrument is that, the GATT?

Mr. VOLCKER. The GATT is concerned about that in setting up the structure of trading rules. The IMF has special leverage because they come in with money. The IMF hasn't got leverage if the country isn't borrowing, but when the country has an adjustment program, that is one of the concerns of the Fund.

Senator MATTINGLY. Is there any way you could write in a conditionality whereas the money—I know the money the IMF is giving to a country should not be used for a subsidy. I mean, they could not acquire money to subsidize exports.

Mr. VOLCKER. I don't know how you trace the money, but the IMF——

Senator MATTINGLY. I guess that's what I'm getting at. What I'm fearful of is that we will give to the IMF funding and they will in turn give money to whatever country it may be—Brazil—and there's no way to say that money going to Brazil is not going to reach other funds in Brazil to in fact subsidize exports in that country.

Mr. VOLCKER. In some sense, that is true, but you also can be sure that in these programs the IMF is putting on pressure to reduce that, and they have got a certain leverage. The only direct experience I've had as a Government official in dealing with the IMF on the other side of the table is when they come around to consult with the United States. We are not borrowing from them. We don't have conditional programs. They don't have that kind of leverage over us because we haven't been in that kind of difficulty. But I'll tell you, when you sit at that table, the IMF comes in and says, "What about our trade restrictions; what about our subsidies; are we doing all we can to get rid of them?" It is a standard question, a standard approach that they take with every country, and they can take it more effectively under these circumstances.

Senator MATTINGLY. It may have worked in the past prior to us getting into the trade problems we have now internationally where everybody wants to export more and import less and subsidize it. I would wish you would put the power of your thinking behind what we are trying to get at here, trying to write some conditions into these loans to preclude the usage of those moneys in such a way because I think it's a necessity if we're ever going to settle this in Congress that's just one item that we're going to have to consider.

Mr. VOLCKER. I appreciate your concerns, but I hope I have made clear that I think the whole thrust of the IMF effort is consistent with your concerns.

Senator MATTINGLY. Well, I appreciate your point of view. I'm not quite sure I have that same comfortable, warm feeling coming out of IMF.

Mr. VOLCKER. Let me provide some more material then.

[The following information was subsequently submitted for the record:]

Background Material on External Trade and Payments Restrictions in IMF Balance of Payments Adjustment Programs

The major aim of an IMF-supported adjustment program is to assist a country to bring about a configuration of its balance of payments considered sustainable over time. In this context, what is known as "IMF conditionality" refers to the practice of providing financial assistance only when, in the IMF's judgement, the country involved has formulated and is committed to implementing adjustment policies designed to reestablish a viable balance of payments position. Depending upon circumstances of the individual country, the particular set of policies designed to achieve this objective is likely to contain measures to restrain aggregate domestic demand (through reducing fiscal deficits and restraining growth of money and credit), to improve the efficiency of domestic resource allocation and thereby lay the basis for higher growth in output (by reducing or eliminating price controls and subsidies, reducing external trade and payments restrictions, and moving toward the establishment of positive real interest rates), to improve and maintain external competitiveness (through appropriate exchange rate policies), and to foster net capital inflows (through maintenance of an adequate level of interest rates. appropriate exchange rates, and an overall mix of policies that will attract foreign funds and encourage the retention of domestic savings for use in domestic investment).

If successfully implemented, such policies can be expected to bring about adjustment in the balance of payments through a reduction in the current account deficit (i.e., the net balance of exports and imports of goods and services) to a level that can be sustained through expected future net inflows of capital on terms compatible with the development prospects of the country and without resort to trade and payments restrictions. Such adjustment may, but does not necessarily, entail a temporary reduction of imports. In fact, of the nine largest IMF-supported programs (involving more than SDR 500 million in IMF resources) currently in effect (Argentina, India, Mexico, Pakistan, Turkey, Yugoslavia, Chile, Peru, and Romania), the programs for the first six of these, when approved, anticipated an increase in the value of imports in the first year of the program compared with the prior year. Even in programs that anticipate a temporary decline in imports, IMF financial assistance and other financing that might not otherwise have become available without an IMF-supported program help to cushion the adjustment process and to avoid an even larger decline in imports that might have otherwise occurred as a consequence of harsher and more abrupt adjustment policies. Moreover, the adjustment approach advocated by the IMF attempts to establish a basis for sustained growth of the economy and avoids strictly deflationary policies that may adversely affect investment and fail to stimulate the required shift of resources to the external sector.

As part of conditionality, the IMF places strong emphasis on the reduction and elimination of external trade and payments restrictions. This aspect of conditionality is based upon Article I of the IMF Articles of Agreement which lists explicitly among the purposes of the IMF, the facilitation of "the expansion and balanced growth of international trade" and "the elimination of foreign exchange restrictions which hamper the growth of world trade." In fact, as one of the standard conditions for making drawings that are phased over the life of an IMF program, a member must agree not to impose new, or to intensify existing, trade and payments restrictions. But the

IMF often goes beyond the proscription against imposing further restrictions by actively encouraging members to reduce or eliminate existing restrictions. In some cases (e.g., in the IMF programs of Pakistan and India approved in 1981), a substantial liberalization of restrictions on imports constitutes an explicit major element in approval of IMF-supported balance-of-payments adjustment programs. The IMF also encourages members to reduce or eliminate subsidies that tend to stimulate exports and/or imports because of their distorting influence on resource allocation and their contributions to budgetary deficits.

In addition to the influence exercized through the provision of balance of payments assistance, the IMF actively encourages the reduction and elimination of restrictions or artificial incentives affecting current transactions or payments, or capital flows, through its surveillance over exchange rate policies of member countries, both for industrial and developing countries. These surveillance responsibilities flow from Articles I and IV of the Articles of Agreement which obligate member countries to maintain orderly exchange arrangements, to avoid competitive exchange depreciation, and to promote a stable system of exchange rates.

Senator MATTINGLY. I wish you would. Thank you very much.

Senator HEINZ. Chairman Volcker, we appreciate you being here. I have one last question for you before we call on Mr. Conover and Mr. Isaac and it's a little different from the ones you've received so far.

MORE CAUTIOUS WITH FUTURE INTERNATIONAL LENDING

As you know, there are some experts that argue that the current situation with the overexposure in countries like Brazil, Argentina, and Mexico are going to make the banks, particularly the big money center banks, more cautious in the future with their international lending.

I wonder if we really have any experience from the past that sheds any light on that because it seems to me that if official assistance through the IMF helps the largest debtor countries out of their difficulties, then banks in fact not only will not suffer any loss in earnings but indeed they are going to experience, as I understand the vicissitudes of rescheduling, they are going to actually experience increases in their earnings. And why isn't that an incentive for banks to say, "Well, say, this didn't work out so badly last time; as a matter of fact we extended a lot of credit we shouldn't have extended and along came the international rescue posse and we got a higher interest rate on our loans. Gee, that is a great way to do business. I can hardly wait for the next international crisis to come along. Our profits went up."

Mr. VOLCKER. I well understand your concern, and that's the basic reason why I think it is perfectly legitimate to raise these supervisory questions as to how we approach these problems and what the reserve needs are and how to deal with front-end fees on loans. How do we get the right balance of incentives and disincentives here? I think, in fact, the banks will be more cautious and should be more cautious over a period of time, but let me conclude, by saying——

Senator HEINZ. You're not going to get away quite that easily.

Mr. VOLCKER. I would be happy to stay, but I think there is a danger in overreaction. As I said in my statement, the most dangerous thing we face today is not an excess of exuberance on the part of the banks——

Senator HEINZ. Or the bank regulators.

Mr. VOLCKER. The danger we face is in everybody running for cover so fast that they're mutually destructive. We have to work within that framework. We want a balance here.

Senator HEINZ. Chairman Volcker, I don't think anybody is suggesting that we ought to make it tougher for banks to do what they have to do in terms of not pulling the plug on any of these countries. Of course that's not what anybody responsible is saying, that we want to put something on the books or we want to tell you to do something that will cause all these banks to pull out of these syndications that will shatter the international financial system.

But what I'm asking you is, don't you think we ought to give you direction to establish a prospective system of loan loss reserves against nonperforming loans in the future so that rather than having an increase in profit when there's an international financial crisis that we come forward with $8.4 billion to surmount, that indeed there is some recognition on the bottom line of the bank that things didn't really work out all that well.

Mr. VOLCKER. I will answer your question in two ways. I think the sense of the Congress—your giving us a general sense of direction and mandate in this area—is desirable. The specifics of an arrangment of that sort—and I think you're touching upon an area that we are looking at very hard, a promising area—the specifics, I'd like to reserve on.

Senator HEINZ. But you think that it is not inconceivable that we might want to do something in that area.

Mr. VOLCKER. Whether you want to put anything explicitly in the law, I don't know.

Senator HEINZ. I used that word "we," I didn't necessarily mean just Congress. I meant regulators and Congress together.

Mr. VOLCKER. In fact, in this area we have been making studies. The regulatory agencies together began looking into this matter a year ago.

Senator HEINZ. Chairman Volcker, thank you very much. We appreciate your fortitude in continuing to appear before this committee.

Mr. VOLCKER. I enjoy it.

[Complete statements of Mr. Volcker follow:]

Opening Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to have this opportunity to exchange views with the Committee on the international financial situation and the role of the International Monetary Fund. I have elaborated at some length on these issues in a statement, replete with data and appendices, that I presented two weeks ago to the House Committee on Banking, Finance and Urban Affairs and that I have submitted to this Committee as well. Today, I would simply like to update that statement and highlight the major points.

We face extraordinary pressures in the international financial system. While conditions in the market have been calmer in recent months, in large part because of responsible actions by all the parties involved, the underlying problems persist.

This is not an abstract, esoteric problem of marginal interest to our economy. Failure to address these problems will jeopardize our jobs, our exports, and our financial system. Unless it is dealt with effectively, it could undermine both our own recovery and the economies of our trading partners and friends abroad.

I am confident that the situation can be managed -- but it won't manage itself. My confidence is based in part on the fact that I think the nature of the problem and the needs are well understood. Governments have worked together in analyzing and dealing with the problem; we have seen the borrowers and lenders working together effectively; and the IMF -- as the designated international overseer of the system -- has been at the center of the process, fulfilling its key role in coordination, providing money in some cases, and promoting necessary economic adjustment.

As we deal with the heavy indebtedness and balance of payments problems of some large developing countries, five interrelated elements stand out.

The first step is that the borrowing countries themselves must adjust. This means strong and forceful measures -- basically austerity programs -- have to be taken by these countries to cope with their internal and their external imbalances, typically with the support and approval of the International Monetary Fund. For example, the reductions in public sector borrowing requirements committed under IMF programs for Argentina, Brazil and Mexico are demanding: they require roughly a halving of deficits over the course of the year.

Forceful adjustment programs will be accompanied, for a time, in slow or no growth internally, reduced imports, and lower living standards in countries where average incomes are already far below ours. The question is sometimes put as to the wisdom of these programs in a world eager for growth. The answer is straightforward. Those programs are fundamentally justified by two basic considerations: 1) In the absence of coherent adjustment programs that can command support in the international financial community and among other Governments, still more severe and lasting difficulties would ensue as borrowing countries found their access to external resources abruptly cut off; and 2) Well-conceived adjustment programs can lay the base for resuming growth at a sustainable rate for years ahead.

A second element in dealing with the current problems is that, considering the large imbalances the major borrowing countries have faced, an orderly adjustment effort will require additional external credit support during a transitional period. In important cases, restructuring of existing loans and agreement among bank lenders to provide additional credit have become essential. Because adjustment is contemplated and is proceeding, those fresh credits can typically be provided without increasing exposure of the banks in terms of ratios of loans to capital or assets, and in fact with some declines in those ratios.

Third, monetary authorities of some of the industrialized countries have provided temporary liquidity assistance while IMF stabilization programs and associated finance are being negotiated and while the banking packages are being put together. This is something that should not become a norm, but it is justified to maintain continuity in payments and confidence when there is a clear threat to the international financial system.

Fourth, as the earlier points imply, the IMF plays an absolutely essential role, and it needs adequate resources to do its job. It works closely with the borrowing countries themselves, particularly in reaching agreement on stabilization programs to restore economic balance and in maintaining confidence in their creditworthiness. As part of that process, the IMF provides a key element of medium-term finance in support of agreed adjustment programs. Complementing its own resources, it has also helped coordinate the needed private (and sometimes public) financing. It does not itself replace other sources of financing, but supplements them.

Finally, the success of the adjustment programs and the relaxation of pressures on borrowers and lenders ultimately is dependent upon the performance of the world economy. In an environment of sustained growth in the industrial countries, the borrowing countries themselves can more easily resume growth, their debt burdens will become more manageable, and their adjustment less burdensome. "Normal" financing patterns can be resumed -- not in the sense of the excessive growth of some recent years, but in the sense that lenders and borrowers can freely and individually negotiate mutually acceptable terms free of critical liquidity pressures.

That objective of growth coincides, of course, with our domestic concerns. Conversely, if we fail to come to grips with the international financial situation the prospects for growth in the industrialized world, including the United States, would be impaired. Our concern for maintaining a well-functioning international financial system is rooted in our self-interest, not altruism.

I will not review now the material in my earlier statement about the development of bank lending in earlier years and the lessons for banks and supervisors alike growing out of that experience. Suffice it to say that much of this lending reflected a constructive response by the financial system to the need to ease the adjustments associated with the world oil crisis. International lending will continue to have an important role to play in a developing world economy.

But, of course, there can be excesses, and some of the lending proceeded on assumptions that, in retrospect, seem invalid. None of us enjoys perfect foresight, and it remains central to our financial and economic system that the individual lenders reach their own credit judgments. But it is the responsibility of government to establish and maintain ground rules and procedures that, without stifling the market, provide assurance that the stability of the system as a whole can be protected against the dangers of excessive concentration of risk, and that the element of risk is appropriately weighed. While our present supervisory approaches are aimed at that objective, the rapid development of international lending and today's problems do point to the need for careful review of present policies and other ideas. Possible modified or new approaches -- touched upon in my earlier statement -- are under intensive review by the supervisory agencies, and I expect to be able to report conclusions to you in a matter of weeks.

At the same time, the danger of over-reaction -- of encouraging inadvertently an abrupt retreat from lending -- is equally real. The hard fact is few borrowers, at home or abroad, can suddenly repay substantial debts accumulated over years. An attempt to force the process would be doomed to failure, because borrowers need time to make the adjustments to earn the funds or to restore their market access. What may seem logical and appropriate to an individual bank in demanding payment, if generalized, would place such strain on the system as a whole that it, and the individual banks within it, could only be damaged.

As I noted earlier, the parties immediately at interest in resolving the international debt problem -- lenders and borrowers, governments and the private lending institutions, and international organizations -- have been acting cooperatively to deal with the major points of pressures to the financial system. The IMF stands in the center of this effort, and it has responded with force and leadership.

Last week, at the meetings of the Interim Committee, member governments of the IMF reached agreement -- subject to legislative approval -- to expand the effective resources of the IMF, and to do so promptly. Recent events have ended any doubt about the need for a substantial increase in resources of the Fund -- a matter that had been under discussion before the strains had become so evident last summer. The amount agreed last week -- at the lower part of the range that had been under discussion -- does not seem to me at all excessive, but it will enable the Fund to discharge its large responsibilities with effectiveness and confidence that the resources it may need will in fact be available.

Last week's decision increased IMF quotas by about 47.4 percent, or by about $32 billion. The Group of Ten earlier approved an enlargement and broadening of the General Arrangements to Borrow (GAB) from $7.1 billion to about $19 billion, supplementing in time of need the resources available to the Fund.

Both the quotas and the expanded GAB essentially provide a standby commitment, with equitable sharing among countries, to contribute to a pool of funds that can be drawn upon for loans to IMF member countries in time of need. As more funds are borrowed by a country, stricter conditions are required.

The increase in IMF quotas and the enlarged GAB require budgetary authority and appropriation for the full amount of these commitments, involving about $8.4 billion for the United States. These commitments, however, do not lead to a net budget outlay, in recognition of the monetary and reciprocal character of the IMF. Moreover, cash advances will be necessary only when and if demands on the IMF exceed amounts that can be provided from current IMF resources -- and that will only happen in the foreseeable future if, in fact, the Fund requires these added funds to deal with a major threat to the system. In a sense, the U.S. and other countries assume the position of insurance underwriter, called upon with a showing of demonstrated need. What we are insuring, among other things, is that our own recovery will not be aborted by international financial disturbances.

The events of recent months have highlighted both the risks and the means for dealing with them. The pressures on the international financial system have not disappeared, and we cannot assume some hidden hand will manage the solution.

As the economic, financial and political bellwether of the Western World, we cannot escape the responsibility of leadership and participation in the effort -- not if we want the effort to succeed in our own interest. Early approval of the IMF legislation that will be submitted to Congress shortly will be an indispensable step to that end, reflecting our determination and capacity to do our part in reaching a constructive and effective resolution of the problem.

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am glad to have this opportunity to discuss some recent international economic and financial problems and measures to deal with them. These problems have emerged in the context of deep and prolonged recessionary forces in the industrialized world, with severe unemployment of labor and productive facilities, stagnation of private investment initiatives, and strains on the financial capabilities of many borrowers and lenders, domestic as well as international. At the same time, some signs of recovery are emerging in the United States, there has been striking progress against inflation, and active efforts are underway to deal with and contain the problems in the financial system. We now have an opportunity to build a prolonged expansion on the basis of a far healthier outlook for price stability and productivity.

One of the potential threats to that outlook arises in the area you have requested that I particularly concentrate on today -- the heavy indebtedness of some developing countries and the related exposure of the commercial banking system of the industrialized world. Failure to manage and diffuse these strains could deal a serious blow to the recovery of the United States and the world economy. But the essence of my testimony today is that that problem is increasingly well understood, and on the basis of that understanding, for all its complexity and difficulty, it can be dealt with effectively. The United States, and the United

States Congress, have a key role to play in that process, alongside international institutions and other countries.

A successful program must rest on action in several inter-related areas, involving a high degree of cooperation among countries and among lenders, coordinated in large part by the International Monetary Fund. The necessary approach falls under five main headings:

(a) An indispensable first step is determined action by major borrowing countries to change their economic policies to cope with the realities of their situation -- that is to reduce internal and external imbalances. Typically, measures are required to cut down on very high rates of inflation and budget deficits, to establish realistic foreign exchange rates and domestic interest rates, to encourage greater economic efficiency, and, as a result, to aim for substantial reductions in external deficits. Working with the IMF in developing such programs, culminating in IMF approval of medium-term credit assistance, can be a critically important signal to other lenders that a country is committed to an effective adjustment program.

We are now seeing that process in action; Argentina, Brazil and Mexico -- the largest international borrowers among the developing countries -- have reached agreement with the IMF on a set of economic policies that will satisfy the basic requirements for receiving financial support from that institution. A number of other countries have already established, or are in the process of developing, such programs.

(b) Closely tied in with the adjustment programs worked out between the IMF and the borrowing countries are arrangements among the bank creditors to provide enough continuing credit to maintain continuity of payments and a financial environment in which orderly adjustment programs can be implemented. In important instances, current and future debt maturities have been "rolled over" or restructured, and agreement has been (or is being) reached on some extensions of new bank credit -- conditional on the performance of the borrower in meeting its IMF-agreed program. While the cases of Argentina, Brazil and Mexico have received the greatest attention, similar needs have arisen with other countries. The fact is that few countries are in a position rapidly to repay indebtedness built up over a number of years, just as, in a purely domestic context, many companies or individuals could not suddenly repay debt. Efforts by their creditors to withdraw from lending simultaneously can only be mutually self-defeating, precipitating a financial crisis even where sound adjustment programs are underway.

(c) In specific instances, short-term "bridging" credits by national monetary authorities, acting bilaterally or through the Bank for International Settlements, may be appropriate to meet minimum and immediate liquidity requirements while adjustment and borrowing programs are being arranged. The funds advanced are to be promptly repaid as commercial, IMF, or other credits become available. Both the Federal Reserve and the Exchange Stabilization Fund of the U.S. Treasury have participated in such credits, as reviewed in Appendix I to this statement. These credits have been limited to instances that present a clear threat to international financial stability and where there is adequate assurance of repayment. Monetary authorities have neither the capacity nor the mandate to substitute short-term central bank credit for medium or longer-term financing.

(d) The earlier points emphasize the key coordinating and substantive role of the IMF, and there is a clear need for the resources of that institution to be enlarged so that it can, with assurance, meet the potential demands upon it. There is literally no other body in the world that can effectively combine the several ingredients necessary to encourage both sound adjustment and necessary financing:

- It has legitimacy, as the agreed and politically neutral international vehicle for evaluating national economic programs;
- It has financial capacity, as the organization through which 146 countries, large and small, have provided a pool of funds for meeting transitional, financial needs of its members;
- It has ability, in terms of experience, expertise, and respect by other lenders and borrowers alike.

IMF funding may provide only a relatively small fraction of the funds required by borrowers in specific instances. However, the availability of those funds provides a base for attracting commercial bank and other financing to cover the bulk of the need. Indeed, in instances where countries have had access to international banking markets in the past, the success of IMF programs may require some prior assurance that adequate amounts of private financing will be available for a time. Current and prospective demands could well tax the present resources of the IMF, and sharply impair its ability to encourage orderly financing programs. Consequently, enlargement of quotas and other IMF resources, a matter that has been under consideration in any event, needs to be speeded.

(e) Finally, the success of all these efforts over time in easing current financial strains and pressures will ultimately be dependent upon the elimination or substantial reduction of current account deficits by borrowing countries. That objective will require some combination of reduced imports and larger exports, but it is patently clear that not all countries can achieve those objectives together because we buy and sell from one another. In fact, the strong adjustment efforts by a significant fraction of the world economy will -- other things equal -- tend to damp growth of their trading partners, as well as internally. In the circumstances, an environment of sustained recovery and expansion in the industrialized world is critically important.

In all of this, the mutual dependency of the U. S. economy and the stability of the international financial system should be apparent. Failure to deal successfully with the immediate international financial pressures could only jeopardize prospects for our recovery -- for our jobs, for our export markets, and for our financial markets. Conversely, sustained, non-inflationary growth in the United States and elsewhere is needed to provide an economic environment in which borrowing countries can improve their balance of payments over time and in which debt burdens can be reduced.

The Background of Current Pressures

It is convenient to trace part of the present liquidity crises of some developing and Eastern European countries to the two massive oil price increases of 1973-74 and 1979-80. Since the first oil shock the oil import bill of the non-OPEC developing countries has escalated sharply, reaching more than $20 billion in 1978, and then jumping to more than $50 billion in 1980 and 1981. As a result, some oil importing countries have been burdened with chronically large and growing burdens on their current accounts.(See Table I.)

However, the direct impact of high oil prices on import bills does not provide a full and general explanation of the present difficulties; indeed, some of the most heavily indebted countries are oil exporters or are roughly in balance on oil account. While great differences can be found in specific causes of the resort to huge amounts of external borrowing by particular countries, and in the extent to which they tried to correct the situation, some general "environmental" factors seemed to affect them all.

The borrowing countries have all, understandably, wished to expand rapidly their industrial base to meet the needs of a growing population and increase national income and economic welfare. In fact, after the oil shock of 1973, as a group, they maintained much faster growth than the more mature economies. Some (with Mexico the leading example) benefited from oil development and rising oil exports, the volume of exports of manufactures increased sharply, and world inflation was accompanied by relatively buoyant prices for commodity exports. But in addition, domestic expansion was frequently pressed by budget deficits and relatively low interest rates. As a result, internal inflation and rising current account deficits were common.

At the time oil prices first rose sharply, great concern had been expressed that industrialized and developing countries alike might be unable to finance the increased cost of oil imports. In fact, a rapid expansion of international bank lending, from a low base, helped greatly in "recycling" surpluses of OPEC countries to borrowers, including Eastern European nations and middle-income developing countries. While the debts of those countries rose rapidly, the view was increasingly taken by many banks and others both in the U.S. and elsewhere, that prospects for their future growth were reasonably good, and that on that base, increasing debt burdens in real terms would be manageable. During much of the 1970s, rising world inflation, and low or even negative "real" interest rates greatly moderated the rising debt ratios. Moreover, with credit in ample supply, most of the largest borrowers were able to add substantial amounts to their official reserve assets; taken together the non-OPEC developing countries added $40 billion to their reserves in those years, tending to maintain confidence in their financial management and outlook.

The second great increase in oil prices and other developments in the world economy at the end of the 1970s helped to call some of the favorable assumptions of borrowers and lenders into question. Export markets for manufactures weakened, prices of commodity exports declined, and annual interest payments rose sharply as both the amount of indebtedness and world interest rates escalated. In the interest of prolonging and maximizing internal growth, adjustment measures were delayed or unconvincing, and budgetary imbalances, inflation, and current account deficits increased. Confidence at home was undermined in some cases, leading to capital flight.

In the case of Mexico, the current account deficit reached $13 billion in 1981 in spite of petroleum exports of $14 billion, and Mexicans moved large amounts of money abroad. Mexican external indebtedness rose by $20 billion in a single year, with commerical banks increasing their exposure by nearly $15 billion. Brazil found its oil import bill rising to $9½ billion, and interest payments to $12 billion last year. The result was a current account deficit of about $15 billion, despite adjustment efforts.

Throughout this period, losses on foreign credits of commercial banks continued to be substantially lower than on domestic lending -- as they had been for many years. Foreign lending accounted for a rising share of the assets and the earnings of most large international banks, U.S. and foreign based. The bulk of the lending was undertaken by banks with established international concerns and expertise, and it was to a small group of rapidly growing countries deemed to have good prospects. The poorest countries continued to rely almost entirely on official financing.

As a result, developing country debts to commercial banks are relatively highly concentrated. (See Tables II and III.) Of the $270 billion owed to banks by public and private sector borrowers in all developing countries at mid-1982, over half was accounted for by three countries (Argentina, Brazil and Mexico), and another 10 percent by Chile and South Korea. Eastern European countries owed another $64 billion to banks abroad as of mid-1982, but the share of U.S. banks in total claims on those countries was only slightly more than 10 percent.

The relative participation by U.S. banks in lending to developing countries, while remaining large, tended to decline somewhat in the latter part of the 1970s, holding recently at about 35 percent of the total. The fact that interest margins had been driven to levels that provided little allowance for risk and capital growth seemed at times to moderate the enthusiasm of U.S. banks for foreign lending, and the share of our banks in providing new financing to the largest borrowers declined to less than one-third from 1979 to 1981. (See Table II.) But in absolute terms, the increases remained large, and exposure relative to capital and assets rose. (See Table IV.)

International lending has traditionally been pretty much the province of the largest banking institutions with a long history of experience with international business, extensive information networks through foreign branches, and a resource base capable of sustaining potential losses. During more recent years, more and more essentially domestic banks were drawn into international lending. The amounts loaned, while typically involving less relative exposure, became significant in the aggregate. Nevertheless, of total U.S. bank claims on the developing countries in June, 1982, of about $100 billion, the nine largest banks accounted for 60 percent, and the next fifteen banks for an additional 20 percent.(See Table IV.) These amounts represented a growing commitment of capital resources; for the nine largest banks, claims on all developing countries had grown to about twice their capital by last June, and about half of the claims of those banks were on Argentina, Brazil and Mexico. (See Table V.)

By that time, hundreds of regional and smaller banks around the world had participated to some degree in lending to developing countries through direct credits or as a result of syndications of credits by the large "lead" banks. The largest borrowing countries had well over a thousand bank lenders. Because the participations of smaller banks are, individually, limited in size, many of those banks no doubt assumed that their commitment to foreign lending could be handled quite flexibly, and reduced over short periods of time as their judgment dictated. That normal presumption is, however, called into question precisely at a time of financial crisis for the borrowing country when many banks may want to reduce exposure and other sources of financing are not available. Consequently, the refinancing programs underway have necessarily involved virtually all lending banks.

Supervisory Policies

The rapid development of international lending in recent years has received increased attention by the supervisory agencies here and abroad.

In international lending, several considerations arise beyond the usual "credit" risk -- that is, the ability of the borrower to generate funds in his own country for repayment. Banks are often dealing with sovereign rather than private borrowers. A sovereign borrower can usually generate resources in its own currency and need not meet a "market test" domestically, but the fact that the borrower is a sovereign political body also limits the recourse of the lender, when conditions deteriorate. Both sovereign and private foreign borrowers are subject to "currency" or "transfer" risk -- that is, conditions under which the country will be unable or unwilling to obtain enough foreign exchange to service external indebtedness.

Our traditional approach toward examining banks was not well suited to dealing with these kinds of risk. Individual bank examiners were not generally equipped to evaluate economic conditions and prospects of countries. There was a high degree of variability in the way country lending was handled in examination reports. The traditional criteria for formally "classifying" or "criticizing" loans were developed for private borrowers or local governments, and were not readily adaptable to consideration of "transfer risk" or evaluating sovereign entities. We were also aware that blanket "classifications" of a particular country --

classifications that would necessarily have arbitrary elements -- could have sudden and devastating effects on the availability of credit, sometimes defeating the possibility of orderly adjustment and inviting a misinterpretation that the U.S. Government might be making a political judgment.

In recognition of these problems, the three Federal bank regulatory agencies instituted in 1979 a new system for evaluating country risk. A detailed description of that system is contained in Appendix II to this statement.

In summary, the system has four elements. The first is a statistical report designed to identify the country exposures of each bank on a basis consistent with aggregate data, and to enable the regulators to monitor those exposures.

A second element is an evaluation of each bank's internal system for managing country risk, with the aim of encouraging more systematic internal review of, and judgments about, foreign lending.

As a third element, exposure to a particular country may be "classified," but only on the basis of collective judgment by the examining agencies and in instances where debt service is interrupted (or such interruption is imminent) and unlikely to be promptly resumed.

A fourth and critical element is country-by-country appraisal of each bank's large exposures. The principle underlying that appraisal is that adequate diversification should be the cardinal rule in banks' management of their international portfolios. Neither banks nor their supervisors can expect to anticipate all significant political changes and economic developments. Diversification of a portfolio provides a degree of protection against events in a few countries seriously undermining the earnings and condition of an individual bank.

These appraisals draw upon the findings of an Interagency Country Exposure Review Committee charged with reviewing conditions in borrowing countries. The Committee evaluates conditions in individual countries; with its guidance, examiners review and comment on country exposures which exceed a certain portion of bank's capital.

The overall purpose is to call significant exposures to the attention of senior management and boards of directors of the banks, to raise questions, and to force careful consideration.

This approach obviously involves striking a difficult balance. I am aware, for instance, that in reviewing these procedures, the GAO questioned whether comments were sufficiently pointed, or bank managements adequately sensitized, to influence lending policies appropriately. At the same time, in our system of banking and supervision, the supervisor should not take responsibility for the lending decision, beyond assuring ourselves to the extent feasible that relevant factors are weighed and appropriate procedures followed by those responsible for the management and direction of the banks.

In the light of recent developments, we have in process a re-evaluation of our current approach toward supervision. My own preliminary judgment is that the basic framework of the system introduced in 1979 is constructive and sound, but important questions arise about implementation.

Between mid-1980 and mid-1982, the claims on Mexico of the nine largest U.S. banks grew from 32 to 50 percent of capital funds, with lending terms tightening only toward the end of that period. (See Table V.) Less dramatic but significant increases in these banks' exposures to Argentina and Brazil also occurred. The comments made in examination reports during this period did reflect growing supervisory concerns about the situation in these countries and the potential for payment difficulties. However, questions naturally arise as to whether those comments were stated forcefully or early enough, whether they were considered carefully enough by the banks -- or, indeed, whether that kind of approach to the problem, involving the most difficult kind of judgment by banks and supervisors alike, needs to be supplemented by other techniques.

There are several possibilities for consideration. One approach would be to consider setting formal limits, by law or regulation, on bank exposures in different countries. In effect "single country" limits analogous to "single borrower" limits would be imposed. Such limits, while capable of enforcing diversification, have inherent difficulties. They would inevitably be arbitrary, unable to distinguish among the capabilities of different banks, the size and conditions of different countries, or different types of borrowers -- the government, public agencies, financial institutions, and non-bank private entities -- within a country. (See Table VI.) If applied judgmentally and changed from time to time, they would imply inherently controversial economic political judgments about other countries by the U.S. Government.

I would note the present system already uses various ratios of exposure to capital as a threshold point for commenting on exposures in certain countries. We will want to examine whether we can build on that approach while retaining important elements of flexibility.

Looking to the future, another possible approach would be to promote, through accounting and reserving practices, appropriate financial incentives. For instance, practices in accounting for "front end" fees in large syndicated credits appear to differ, and a conservative and uniform approach could be encouraged. There has been some discussion here and abroad about the possibility of more formal rules, based on rather specific criteria, for setting up specific prudential reserves against severely troubled country credits. That approach would build upon and supplement the existing practice of establishing loan loss reserves in relation to the risk in particular loans and the unforeseen risk in the total portfolio. Provision for reserves of that kind would impact on current earnings, and in some instances there may have been reluctance to "penalize" earnings, particularly with respect to sovereign credits where the argument may plausibly be made that the borrower will not "disappear" or go "bankrupt" in the sense of a private borrower, and interest or principal arrears should ultimately be recovered. Another approach would be to supplement general reserves or strengthen capital ratios for institutions with relatively high concentrations of foreign risk. Experience does demonstrate that countries are not insulated from protracted difficulties, and such provisions would recognize that, all other risks equal, lending abroad has the additional dimension of country risk and should be supported by adequate capital. Seen in this light, it is clear that such an approach would need to be integrated into the analysis of capital adequacy of the banking organization taken on a consolidated basis.

A different approach would be to rely more fully upon public disclosure of large concentrations to promote market discipline. There has already been movement in that direction, but a balance must be struck. When lending is fashionable, there may be little discipline and even incentives to "follow the leader." When sentiment shifts, markets may react abruptly, undermining confidence by simplistic or naive interpretations of the data. Considerations of customer confidentiality and competition impose limits.

There is an additional complication in supervision of international lending. Competitive pressures are heavily conditioned by the behavior of lenders in other countries. To the extent feasible, our approaches should be coordinated with those of banking supervisors abroad, guarding, of course, against tendencies to retreat to the "least common denominator." Recent experience also suggests a need for some re-examination of the scope of, and supervisory approaches to, the operations of banks outside their home country markets, reinforcing the need for a multilateral approach to address considerations of safety and soundness and of competitive equity among banks from different countries.

In sum, there is no easy and obvious answer; banking, by its nature has risks, and none of us can fully protect against the unknown. Moreover, excessive caution can be as damaging as excessive risk. International lending has made an immense contribution to the growth of the world economy and to cushioning the oil price and other shocks. Actual losses have been limited, and the present difficulties are themselves a powerful disciplinary force. We do not want to substitute government credit judgments for those of the banks, and we don't want to curtail the necessary and legitimate flow of bank credit. A sudden excess of caution would be damaging to the world economy, and to the United States, and our supervisory policies should not feed such over-reaction. It is within those parameters that we are examining our own approaches, and will need to review our thinking further with our colleagues here and abroad. I would like to report to you further as that process is completed.

Bank Lending as Part of Adjustment Programs

The situation of the large borrowers among the developing countries has frequently been characterized as a "liquidity" -- rather than a "credit" or "solvency" -- problem. To be sure, events last year unfolded with a speed disconcerting to many lenders, but that is characteristic of liquidity problems when the balance of confidence shifts. The fact remains that each of the major borrowers, given time, can bring large resources to bear on the need to correct their external payments problem and to service their debts.

Many of these nations have already demonstrated a considerable capacity to adjust. Non-OPEC developing countries cut almost $20 billion from their combined trade deficits last year, and Argentina, Brazil and Mexico all had trade surpluses. (See Table I.) Those borrowers have attached the highest priority to that effort in their economic policy making, recognizing their future growth and stability is dependent on access to credit. In a growing world economy, their current account deficits can be reduced to sustainable levels, or for a time eliminated.

In some of the countries, adjustment efforts had begun some time ago. In Argentina, for example, attempts were made to reduce an explosive rate of inflation and correct an overvalued peso, but the war in the South Atlantic undermined those efforts. In Brazil, monetary policy was tightened in 1981 to counter soaring inflation and efforts were made to hold down the current account deficit, which was pushed up by sharply increased interest payments and larger payments for imported oil. In Mexico, the external situation weakened rapidly in 1981 and little had been done to counter that tendency, perhaps in part because oil revenues gave an undue sense of comfort. In all these cases, the effects of the recession in the world economy, and high real interest rates, had not been anticipated, leaving little or no room for maneuver.

Now, each of those countries is putting in place a strong adjustment program. The aim is massive curtailment of large budgetary deficits -- programs that imply changes in taxation and expenditures far beyond anything that, for instance, has been discussed in relation to our own budgetary problem. Money growth is being cut back, and interest rates are in some instances sharply higher. In Mexico and Brazil, growth will be curtailed for a time, and Argentina is expected to recover only part of last year's losses in output.

All of that involves immense economic and political difficulties. The difficulties are justified by the prospect that the austerity programs should also cut external borrowing needs, permit servicing of existing debt, and lay the base for resuming growth on a solid foundation. The programs cannot be successful, however, without liquidity support for an interim period, and the necessary support has required the organized effort of virtually all lending banks.

The first reaction of many banks to the critical situation that emerged for Mexico last year was to reduce or stop new lending; given the size of Mexico's need, the inevitable result was to deplete reserves and jeopardize its ability to service its debt. The more cautious lending attitudes quickly spread to other developing countries, especially those in Latin America. As fears of currency depreciation and capital controls intensified, capital flight helped to aggravate the resulting problems.

There have been a number of occasions in recent years when it was necessary for banks to restructure or renegotiate loans to particular countries. The situation that emerged last year was unique in its scope and potential effects. It involved several major debtors at the same time, and threatened to spread to others, weak and strong alike. It is this potential for cascading liquidity pressures, undermining the stability of the financial system, that has demanded prompt and forceful action by governments, as well as by private institutions, to protect the stability of the financial system as a whole and our own economy. Fortunately, institutions and facilities designed to cope with problems of this kind were in place and can be adapted as necessary to cope with the present circumstances.

It is in this context that organized programs have been needed to combine and coordinate the efforts of the debtors, the commercial banks, the authorities of the major industrial countries, and the International Monetary Fund (IMF).

The issue has not been whether the debtors will have to close the gap in their external payments -- when the supply of credit is curtailed, there is simply no alternative. Nor can private creditors abstain from participation -- limited available official funds, whether short or medium term, could be marshalled to ease the adjustment in some cases, but they should not be dissipated by repayment of private creditors.

The need has been to recognize these imperatives and reconcile them in a way that would promote needed adjustment without intolerable burdens on the debtor countries and the world economy. The aim is to forestall potential threats to the financial system and to economic recovery in a way consistent with future stability.

One element in that solution has had to be organized efforts by banks worldwide to restructure existing loans and to provide enough new credit to satisfy reduced needs as the adjustment programs take hold. Supervisory authorities both here and abroad have recognized that these efforts are necessary to the success of the program. We cannot, of course, abandon our concern for prudence in lending. But we can and do recognize that sound adjustment programs, carefully monitored by the IMF, can contribute to the credit-worthiness of individual countries, as well as to the stability of the financial system as a whole.

In cases like these where moderate amounts of new bank credit and some restructuring of existing debt are required as part of effective adjustment programs and the loans can be serviced, supervisory objectives do not require criticism of the restructured and new loans. Indeed, refusal of banks to participate in such programs could undermine their common interest in maintaining the servicing and the ultimate collectibility of existing credits.

Enlarged IMF Resources

Member countries of the IMF appear close to agreement -- subject to legislative approval -- to expand the effective resources of that institution, and to do so promptly. The decision has not been reached in haste -- discussions about the potential demands on the IMF have been in progress for many months in connection with the Eighth General Review of quotas. Throughout the negotiating process, the United States has emphasized the need to avoid excessively large additions to resources for fear that those resources might be used too freely, or might encourage laxity or delay in adjustment actions where they are necessary. Those concerns, of course, remain relevant, and have been taken into account. But events also conclusively demonstrate that a substantial increase in resources is indeed required to meet potential needs. The amount to be agreed by U.S. negotiators, I feel sure, will not exceed the basic requirements of the IMF if it is to discharge its large responsibilities with confidence and effectiveness.

Recent discussions among the leading countries have focused on an increase in quotas in the neighborhood of 50 percent, or by about $30-$35 billion. The Group of Ten has decided upon an enlargement and broadening of the General Arrangements to Borrow (GAB) from SDR 6.4 billion to SDR 17 billion (or from $7.1 billion to about $19 billion). For the first time, money available through that arrangement could be used for lending to any member country, but only when the borrower has agreed to a major adjustment program and when there is deemed to be a threat to the stability of the international monetary system.

Both the quotas and the GAB essentially provide a commitment to contribute to a pool of funds that can be drawn upon for loans to IMF member countries in time of need. As more funds are borrowed by a country, stricter conditions are required. The aim is to provide assurance that there is adequate, temporary multilateral financial support available for well-designed and executed economic and financial programs.

As I have indicated, in the case of major borrowers like Argentina, Brazil and Mexico, the actual financing that can be committed by the IMF within its resources and under its procedures is only a fraction of the total financial flows that must be organized and maintained. The IMF programs and financing are, of course, in the interests of banks and other lenders, because they have a large stake in the stability and creditworthiness of the countries involved and in the functioning of the system as a whole. But as I have emphasized, the programs and IMF participation do not contemplate banks can "bail out" of existing loans, and they are, in fact, called upon to play a responsible part in the lending process.

The precise share of the United States in the proposed quota increase is not yet finally agreed, but is likely to be less than 20 percent. Our share of the enlarged GAB is contemplated at 25 percent, involving about $4.7 billion at current exchange rates for the dollar. About $2 billion of that amount will be covered by our current $2 billion commitment to the present GAB, an amount that has been unchanged for more than 20 years.

These are standby commitments. They will involve cash advances only when and if demands on the IMF exceed amounts that can be provided from current resources. IMF facilities are reciprocal; in case of need, the United States can draw on resources provided to the IMF by other countries.

Commitments for increases in IMF quotas and for an enlarged GAB require budget authority and appropriation for the full amount. They do not, however, lead to a net budget outlay, in recognition of their monetary and reciprocal character. Should the IMF call upon the U.S. commitment, there is an equal and offsetting debit and credit to the appropriation account, as the cash transferred to the IMF is reflected in an increased U.S. reserve position in the Fund. That reserve position is freely available to us in time of foreign exchange need.

Transfer of cash to the IMF does add to the borrowing requirements of the Treasury; there is a corresponding reduction in borrowing requirements when dollars are received by the Treasury from the Fund as a result of repayments to the IMF or U.S. drawings. To the extent that the IMF's lending activity is apt to increase during periods of global economic recession, and decline during periods of prosperity, any marginal effects on credit markets are ameliorated. Relative to the totality of U.S. financial markets, these flows will be relatively modest; for long periods, the funds may not be used at all. To the extent funds are drawn, interest is paid at levels related to average short-term interest rates in major countries.

Questions have been raised about the impact of IMF lending programs on our economy relative to domestic credit programs. That is a difficult comparison to make. As noted, our commitments to the IMF are standby and reciprocal, and drawings on those commitments are likely to be short term and reversible. The operations are not aimed at a particular part of the economy, nor are subsidies to one sector of the U.S. economy or another involved. To be sure, some of the IMF advances to borrowing countries, whether or not the United States is the immediate source of the funds, are likely, directly or indirectly, to be spent on U.S. exports. Some of the funds may promptly find their way back into the U.S. banking system or credit markets.

But those technical comparisons should not obscure the basic point of the IMF commitment. The strengthening of the IMF is an integral part of the overall effort to defend the stability of the international financial system. The success of that effort will not be measured by the amount of dollars drawn, but by its contribution to confidence that governments can and will work together to assure that the financial system can and will withstand strains and pressures, continuing to function effectively in the interest of every country.

That concern is not abstract or altruistic. The international financial system is not separable from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, we are not considering esoteric matters of international finance, or primarily what is in the interest of heavily indebted developing countries, although that is involved. We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.

Conclusion

I do not minimize the pressures on the international financial system, and the implicit risks. Those risks in the most immediate sense are financial and economic, but they could potentially be broader than that, affecting the cohesion and political relationships of the Western world.

At the same time, I can only be encouraged by the understanding and cooperation that have marked the response to the difficult circumstances -- by governments and central banks, by private financial institutions, and not least, by the borrowing countries themselves that carry the most difficult burden. The IMF stands at the center of the process, and has responded with force and leadership.

We -- the United States and other countries, lenders and borrowers, banking supervisors and those supervised -- have much to learn from this experience. No single action -- no magic wand -- is available to assure success.

What is sure is that, working together, solutions can be found and are being found. That effort does, and will continue to,demand the active participation of the United States. As the largest economy, increasingly dependent on world trade and finance ourselves, we cannot escape that responsibility.

The benefits of the total effort, which many countries are sharing, will be broadly felt. Our own direct stake is large, for we are dealing with a potential obstacle to our objective of moving from recession into a period of long-sustained growth. And, as we do so, we will have made an enormous contribution to a world economic environment in which the acute debt problems of today will recede and the international financial system can support growth in investment, trade and economic activity.

TABLE I

Selected Data for Non-OPEC Developing Countries

	Growth Rate OECD (percent)	Growth Rate Developing Countries (percent)	of which: Western Hemisphere (percent)	Gross External Debt (millions of dollars)	Debt to Foreign Banks (millions of dollars)	Total Reserves minus gold (millions of dollars)
1973	6.1	6.7	8.4	110[1/]	35[1/]	25.9
1974	0.7	5.6	6.9	135[1/]	50[1/]	28.1
1975	-0.2	4.2	3.2	165	62.7	27.1
1976	4.8	6.6	5.5	200	80.9	38.2
1977	3.8	5.4	5.0	250	94.3	52.1
1978	4.0	5.6	4.5	310	131.3	66.0
1979	3.1	5.0	6.7	365	171.0	76.7
1980	1.2	4.7	5.9	430	210.2	76.8
1981	1.5	2.5	0.5	505	253.5	74.7
1982	-0.8^{e}	1.2^{e}	-0.7^{e}	550^{e}	268.3(June)	69.3(Oct.)

1/ The estimates for these years were done without the benefit of BIS-reported bank lending data, which are only available beginning in 1975.

c = estimate.

TABLE I - continued

Selected Data for Non-OPEC Developing Countries

	Debt Service % of Exports	Change in Commod-ity prices (percent)	Gross Oil Imports2/ (billions of dollars)	Trade Balance (billions of dollars)	Gross Interest Payments (billions of dollars)	Current Account Balance (billions of dollars)
1973	n.a.	53.2	4	-7	n.a.	-6
1974	15.9	28.0	15	-24	9	-24
1975	17.9	-18.2	14	-30	10	-32
1976	16.8	13.2	16	-16	11	-19
1977	17.4	20.7	19	-13	14	-14
1978	21.9	-4.7	20	-24	20	-26
1979	21.9	16.5	31	-35	28	-41
1980	20.0	9.7	50	-56	40	-64
1981	22.9	-14.8	53	-59	55	-74
1982	27.2	-12.1^{e}	47^{e}	-40^{e}	58^{e}	-60^{e}

1/ IMF index, 1968-70=100 (does not include oil).
2/ Net of oil refined and re-exported.

e = estimate.

TABLE II

Bank Claims on Developing Countries
(billions of dollars, end of period)

	Total	U.S. Banks	Non-U.S. Banks 2/	U.S. Share of Total (%)	U.S. Share of Annual Increase (%)	Weighted-average Spread on Medium-term Credits 3/
1975 1/	62.7	34.3	28.5	54.5	n.a.	1.65 4/
1976 1/	80.9	43.1	37.8	53.3	48.4	1.87 4/
1977	94.3	46.9	47.4	49.7	28.4	1.75
1978	131.3	52.2	79.1	39.8	14.3	1.31
1979	171.0	61.8	109.2	36.1	24.2	0.82
1980	210.2	75.4	134.8	35.9	34.7	0.85
1981	253.5	92.8	160.7	36.6	40.2	1.05
1982 (June)	268.3	98.6	169.7	36.7	39.2	1.20 5/

Bank Claims on Argentina, Brazil and Mexico

	Total	U.S. Banks	Non-U.S. Banks 2/	U.S. Share of Total (%)	U.S. Share of Annual Increase (%)
1975	31.5	18.7	12.8	59.4	n.a.
1976	42.5	24.7	17.8	58.1	54.5
1977	50.2	25.8	24.4	51.3	14.3
1978	63.2	26.8	36.4	42.4	7.7
1979	83.0	29.9	53.1	36.0	15.7
1980	108.1	37.0	71.1	34.2	28.3
1981	134.5	46.7	87.8	34.7	36.7
1982 (June)	145.0	52.4	92.6	36.1	54.3

1/ Data for 1975-76 are not fully comparable with those for later years.

2/ In recent years, the dollar value of claims of non-U.S. banks has been reduced as a consequence of the dollar's appreciation.

3/ Federal Reserve staff sample.

4/ Fourth quarter.

5/ First three quarters.

n.a. Not available.

TABLE III

U.S. and Non-U.S. Bank Claims on Major Borrowers, June 1982
(billions of dollars)

Country	Total	U.S.	Non-U.S.	U.S. % share
1. Mexico	64.4	24.3	40.1	37.7
2. Brazil	55.3	20.7	34.6	37.4
3. Venezuela	27.2	11.1	16.1	40.8
4. South Korea	20.0	8.7	11.3	43.5
5. Argentina	25.3	8.6	16.7	34.0
6. Chile	11.8	6.3	5.5	53.4
7. Spain	23.7	5.7	18.0	24.1
8. Philippines	11.4	4.8	6.6	42.1
9. Taiwan	6.4	4.4	2.0	68.8
10. Colombia	5.5	2.7	2.8	49.1
11. Greece	9.7	2.7	7.0	27.8
12. Yugoslavia	10.0	2.5	7.5	25.0

Source: (1) BIS semi-annual maturity survey; (2) U.S. Country Exposure Lending Survey (data adjusted to a BIS basis).

TABLE IV

Claims on Non-Oil Developing Countries: Country Exposure Lending Survey Data for Nine Largest Banks
(billions of dollars)

		Claims on Non-Oil Developing Countries	Reporting Banks' Total Assets	Reporting Banks' Total Capital	Claims on Non-Oil Developing Countries as a percent of:	
					Total Assets	Total Capital
1977	December	30.0	372.5	18.4	8.1	163
1978	June	31.0	390.2	19.0	8.0	164
	December	33.4	422.5	20.0	7.9	176
1979	June	35.0	449.8	21.1	7.8	166
	December	39.9	486.1	21.9	8.2	182
1980	June	41.9	508.4	23.0	8.2	182
	December	47.9	531.0	24.0	9.0	199
1981	June	51.6	553.7	25.0	9.3	206
	December	57.6	564.6	26.1	10.2	220
1982	June	60.3	566.3	27.1	10.6	222

Claims on Non-Oil Developing Countries: Country Exposure Lending Survey Data for Next Fifteen Largest Banks
(billions of dollars)

		Claims on Non-Oil Developing Countries	Reporting Banks' Total Assets	Reporting Banks' Total Capital	Claims on Non-Oil Developing Countries as a percent of:	
					Total Assets	Total Capital
1977	December	8.8	145.0	8.3	6.1	106
1978	June	9.3	150.7	8.7	6.2	107
	December	9.9	166.0	9.0	6.0	110
1979	June	10.3	175.2	9.5	5.9	108
	December	11.3	188.1	10.1	6.0	112
1980	June	12.5	196.6	11.0	6.4	114
	December	14.2	207.1	11.4	6.9	125
1981	June	15.4	221.5	11.5	7.0	134
	December	17.4	233.8	12.2	7.4	143
1982	June	19.0	241.1	12.7	7.9	150

TABLE IV - continued

Claims on Non-Oil Developing Countries:
Country Exposure Lending Survey Data for All Reporters
(billions of dollars)

	Claims on Non-Oil Developing Countries	Reporting Banks' Total Assets	Reporting Banks' Total Capital	Claims on Non-Oil Developing Countries as a percent of: Total Assets	Claims on Non-Oil Developing Countries as a percent of: Total Capital
1977 December	46.9	717.1	40.9	6.5	115
1978 June	48.7	747.9	42.5	6.5	115
December	52.2	823.6	45.0	6.3	116
1979 June	54.4	867.8	47.4	6.3	115
December	61.8	941.3	49.9	6.6	124
1980 June	66.2	999.1	53.9	6.6	123
December	75.4	1,066.3	57.0	7.1	132
1981 June	82.3	1,119.3	59.9	7.4	137
December	92.8	1,164.5	62.7	8.0	148
1982 June	98.6	1,192.4	66.2	8.3	149

TABLE V

Claims on Selected Developing Countries for Nine Large U.S. Banks

Date	Claims (billions of dollars)			Total 3 Countries
	Argentina	Brazil	Mexico	
1977 December	1.8	7.7	6.1	15.6
1978 June	1.9	8.0	5.9	15.8
December	1.8	8.5	6.1	16.4
1979 June	2.1	8.8	5.8	16.7
December	2.9	8.8	6.5	18.2
1980 June	3.3	9.1	7.3	19.7
December	4.2	9.4	9.1	22.7
1981 June	4.6	9.7	10.2	24.5
December	5.2	10.6	11.6	27.4
1982 June	5.3	11.8	13.4	30.5

Date	Claims as Percent of Capital			Total 3 Countries
	Argentina	Brazil	Mexico	
1977 December	9.8	41.8	33.2	84.8
1978 June	10.0	42.1	31.1	83.2
December	9.0	42.5	30.5	82.0
1979 June	10.0	41.7	27.5	79.1
December	13.2	40.2	29.7	83.1
1980 June	14.3	39.6	31.7	85.7
December	17.5	39.2	37.9	94.6
1981 June	18.4	38.8	40.8	98.0
December	19.9	40.6	44.4	105.0
1982 June	19.6	43.5	49.4	112.5

TABLE V - continued

Claims on Selected Developing Countries
for Next Fifteen Largest Banks

Date	Claims (billions of dollars)			Total 3 Countries
	Argentina	Brazil	Mexico	
1977 December	0.5	2.3	2.5	5.3
1978 June	0.6	2.4	2.3	5.3
December	0.5	2.6	2.2	5.3
1979 June	0.7	2.6	2.2	5.5
December	1.0	2.4	2.4	5.8
1980 June	1.3	2.6	2.4	6.3
December	1.4	2.6	3.2	7.2
1981 June	1.6	2.8	3.4	7.8
December	1.7	3.0	4.3	9.0
1982 June	1.8	3.6	4.9	10.3

Date	Claims as Percent of Capital			Total 3 Countries
	Argentina	Brazil	Mexico	
1977 December	6.0	27.7	30.1	63.9
1978 June	6.9	27.6	26.4	60.9
December	5.6	28.9	24.4	58.9
1979 June	7.4	27.4	23.2	57.9
December	9.9	23.8	23.8	57.4
1980 June	11.8	23.6	21.8	57.3
December	12.3	22.8	28.1	63.2
1981 June	13.9	24.3	29.6	67.8
December	13.9	24.6	35.2	73.8
1982 June	14.2	28.3	38.6	81.1

TABLE V - continued

Claims on Selected Developing Countries for All Reporting Banks

	Claims (billions of dollars)			
Date	Argentina	Brazil	Mexico	Total 3 Countries
1977 December	2.6	12.0	11.2	25.8
1978 June	3.0	12.4	10.8	26.2
December	2.8	13.4	10.7	26.9
1979 June	3.4	13.6	10.4	27.4
December	4.8	13.6	11.5	29.9
1980 June	5.6	14.0	12.8	32.4
December	6.9	14.5	15.7	37.1
1981 June	7.5	15.2	18.1	40.8
December	8.4	16.8	21.5	46.7
1982 June	8.6	18.9	24.9	52.4

	Claims as Percent of Capital			
Date	Argentina	Brazil	Mexico	Total 3 Countries
1977 December	6.4	29.3	27.4	63.1
1978 June	7.1	29.2	25.4	61.6
December	6.1	29.4	23.5	59.0
1979 June	7.2	28.8	22.0	57.9
December	9.6	27.3	23.1	60.0
1980 June	10.4	26.0	23.8	60.2
December	12.1	25.4	27.5	65.1
1981 June	12.5	25.4	30.2	68.1
December	14.0	28.0	35.9	78.0
1982 June	13.7	30.1	39.7	83.6

TABLE VI

Amounts Owed to U.S. Banks by Foreign Borrowers, June 1982
(billions of dollars)

	Total Claims	Portion Owed by: Banks	Public Borrowers	Private non-Bank Borrowers
To nine largest banks				
Non-OPEC developing countries	60.3	15.9	22.7	21.7
Argentina	5.3	1.1	1.9	2.4
Brazil	11.8	3.6	4.1	4.1
Mexico	13.4	2.2	5.6	5.6
To next fifteen largest banks				
Non-OPEC developing countries	19.0	8.2	4.3	6.5
Argentina	1.8	0.7	0.5	0.6
Brazil	3.6	2.0	0.8	0.8
Mexico	4.9	0.7	1.2	2.7
To all reporting banks				
Non-OPEC developing countries	98.6	33.0	31.6	34.0
Argentina	8.6	2.5	2.7	3.4
Brazil	18.9	7.9	5.5	5.5
Mexico	24.9	4.4	8.8	11.7

Appendix I

Participation in Bridging Credits by U. S. Monetary Authorities

During the past year, the U. S. monetary authorities have provided, or participated in the provision of, short-term, bridging credits to Mexico, Brazil, and Argentina to help these countries meet their minimum and immediate liquidity requirements while adjustment and borrowing programs were arranged. These credits have sometimes been provided in cooperation with the Bank for International Settlements (BIS) and monetary authorities in other industrial countries. A bridging credit was also provided to Hungary in 1982 in which the United States did not participate, and a bridging credit for Yugoslavia, in which it is proposed that the United States might participate, is under active discussion. This appendix summarizes the arrangements for Mexico, Brazil and Argentina.

Mexico

The Federal Reserve has had a swap arrangement with the Bank of Mexico since 1967. That arrangement is for a total of $700 million. The Bank of Mexico drew $600 million on that arrangement on April 30, 1982 and repaid on May 1, drew $200 million on June 30 and repaid on July 1, drew $700 on July 31 and repaid on August 1. Finally, the Bank of Mexico drew $700 million on August 4. A portion of that drawing has now been repaid and the remainder is expected to be repaid within the next month.

The Exchange Stabilization Fund (ESF) of the U. S. Treasury has had swap arrangements with the Bank of Mexico since the 1930s. On August 14, 1982, the ESF entered into a $1 billion short-term swap arrangement with the Bank of Mexico. Drawings under the arrangement were repaid on August 24 with the proceeds from an advance payment on oil purchases for the Strategic Petroleum Reserve by the Department of Energy.

The ESF and the Federal Reserve both participated in a $1.85 billion bridging facility provided to the Bank of Mexico under the aegis of the BIS on August 30, 1982. The U. S. monetary authorities provided half the total amount through parallel swap arrangements -- the ESF $600 million and the Federal Reserve $325 million. The Bank of Mexico has drawn on these facilities in the past five months to meet its urgent financing requirements while Mexico has put into place its IMF-approved economic stabilization program and arranged a financing package with the commercial banks. These drawings are expected to be repaid by the end of August 1983.

Brazil

In October and November of last year, the ESF entered into swap arrangements with the Central Bank of Brazil to provide a total of $1.23 billion in short-term, bridging credit to Brazil. On December 28, the Central Bank of Brazil repaid $500 million, and on February 1 another $280 million was repaid. The remainder is expected to be repaid within the next month as additional IMF and commercial bank credits become available.

The BIS, acting with the support of the ESF and monetary authorities in other industrial countries, provided the Central Bank of Brazil with a $1.2 billion credit facility on December 23, 1982. The ESF on December 13 provided through a swap arrangement an advance of $250 million on the BIS facility which has been repaid. On January 17, 1983, the Saudi Arabian Monetary Authority agreed to support an addition of $250 million to this facility. The BIS expects to be fully repaid by November 1983. As part of the liquidity support arrangements for the BIS provided by the participating monetary authorities, the ESF has agreed to be substituted for the BIS for $500 million of the total credit facility in the unlikely event of delayed repayment by the Central Bank of Brazil.

Argentina

Last week the BIS announced that it is providing a $500 million bridging loan to the Central Bank of Argentina with the support of a group of its member central banks and the U. S. monetary authorities, which is expected to be repaid by the end of May as other funds become available to Argentina. In this case, the Federal Reserve has agreed to provide liquidity support to the BIS as may be necessary in connection with the credit facility including being substituted for the BIS at its request for $300 million of the total credit facility in the unlikely event that the credit remains outstanding for a longer period of time than is now contemplated.

Appendix II

Examination of Country Risk in U.S. Banks

United States bank regulatory authorities are responsible for evaluating the financial condition of U.S. banks and for encouraging the conduct of their operations in a safe and prudent manner. As a matter of general approach and philosophy, U.S. bank supervisors consider a bank as a consolidated entity and seek to apply the same criteria to a bank's domestic and international activities. Some special procedures are required, however, with regard to the international side to take account of the dimension of "country risk," i.e., the possibility that adverse economic, social, or political circumstances may prevent a country's borrowers from making timely repayment of interest or principal. Due to the growth in international lending, expecially in the last decade, an analysis of country risk exposure is now an essential element of evaluation of the financial condition of the largest U.S. banks. Country risk, however, is only one of a number of factors affecting a bank's condition and must be analyzed in relation to each bank's overall condition.

In 1979, the three Federal bank regulatory agencies (the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) adopted a new uniform system for the examination of country risk in bank portfolios. This system replaced various procedures that had attempted to treat country risk in the same format as commercial risk in banks. The new system assures basic uniformity among the agencies, analyzes the lending bank's own capabilities for country risk management, provides for standard criteria for determining when credits should be "classified" due to country risk, and focuses attention on concentrations of lending. Definition and statistical analysis used in the examination process are integrated with the collection of aggregate data on bank foreign lending, greatly facilitating appraisals of individual bank positions relative to the whole and improving the quality of the available data. U.S. bank exposures are evaluated on the basis of their world-wide operations.

The new system has four parts: (1) a listing of significant country exposures, designed in a manner to bring large exposures, relative to capital or other lenders, to the attention of management; (2) comments on large exposures to individual countries (for this purpose, countries are divided into three broad groups depending upon cross classification of risk factors in the country and degree of exposure by the bank); (3) classification of exposures when necessary; and (4) a discussion of the bank's procedures and controls for managing country risk.

The System is administered by an Interagency Country Exposure Review Committee composed of three members from bank supervision staffs of each agency, including at least six senior bank examiners. The primary functions of the Committee are to evaluate "transfer risk" (i.e., the possibility that the borrower may not be able to maintain debt servicing in the currency in which the debt is denominated because of lack of availability of foreign exchange); to place countries into one of three groups for purposes of evaluating and commenting upon bank exposure relative to capital; to provide "country summaries" to be used in the examination report where warranted; and, if necessary, to prepare classification on the basis of transfer risk. (Private foreign credits may be classified by individual examiners on the basis of normal credit analysis.)

"Listing"

The "listing" section of an examination report sets out aggregate exposure country-by-country, subdivided by the nature of the loan or other exposure (i.e.,deposits, letter of credit, etc.). The array of data reflects both risk categories determined by the ICERC and the amount of the exposure relative to a bank's capital funds. Exposures are listed when they exceed 5 percent of capital funds for a country where risks are considered potentially greater, 20 percent for a middle group of countries, and 25 percent for countries in the strongest group. Listing an exposure does not in itself imply criticism; rather, the purpose is to draw attention to those exposures that the bank should more closely monitor because of size and risk characteristics.

Comments on Concentrations of Exposure

As noted in the preceding paragraph, the ICERC places borrowing countries into one of three groups. In making its decision, the Committee relies primarily on: (1) a statistically generated "ratio" screen of risk factors; (2) country studies prepared by the Federal Reserve Bank of New York and the Federal Reserve Board's International Finance Division; (3) oral briefings from the Treasury Department; and (4) information obtained from banks by examiners prior to the meeting. Judgment of a country's standing relative to those three groups is by majority vote of the members of the Committee.

An exposure is subject to mandatory comment in a bank examination report if the amount of credit extended to a country in the "bottom" group exceeds 10 percent of a bank's total capital or if exposure exceeds 15 percent of capital funds to a country in the middle group. In addition, the examiner has the discretion to comment on exposures down to 5 percent for countries in the bottom group and down to 10 percent for the middle group. There are ordinarily no comments on exposures to countries in the top group.

A comment consists of two paragraphs. One paragraph contains a brief statement on conditions prevailing in the country. This paragraph is prepared by the ICERC and cannot be altered by examiners. The comment typically takes into account the presence of an IMF-approved adjustment program in relevant cases. The other paragraph is prepared by the individual examiner on site. It describes the nature of the bank's exposure (e.g., maturities, type of borrower) and trends in that exposure. In relevant cases, the examiner may indicate how the bank's exposure compares to exposure levels in other banks and discuss the bank's future plans for lending in the country.

Classifications Due to Country Risk

A major task of bank examination is to evaluate bank assets. Credits having serious deficiencies are classified in one of three categories: substandard, doubtful or loss. Historically, classification has resulted from perceived deterioration in the financial position of individual commercial borrowers. However, foreign credits may in exceptional cases also be classified due to "transfer" risk. All credits to both public and private borrowers for which repayment is dependent on a flow of foreign exchange would be included in a transfer risk classification. Amounts classified due to "country" risk are added to those classified due to commercial risk, whether domestic or foreign, in determining a bank's asset quality rating.

Since 1979, all transfer risk classifications have been determined through the procedures of the ICERC. Interagency guidelines instruct ICERC to review a country's credits for possible classification only when there has been an actual interruption in external payments or when such an interruption appears imminent. ICERC reviews the reasons for actual or prospective non-payment, sources of external financing available to a country, and measures being taken to restore debt servicing to a sound basis. The presence or absence of an IMF-approved adjustment program would be a relevant factor. Classification is by majority vote of the Committee members.

Once a classification is imposed, it is not removed until a country has demonstrated, on a sustained basis, that it is able to service its debts (which have usually been restructured) in an orderly manner. A country should also demonstrate an improvement in its economic position, especially as it affects the country's external accounts.

Evaluation of a Bank's System for Monitoring Country Exposure

Another function of the examination system is to ascertain that banks are properly supervising their country exposure. Examiners are instructed to review three major aspects of banks' systems: (1) the measurement and monitoring of country risk; (2) the procedures for establishing and changing country limits; and (3) the procedures for evaluating countries. Examiners are expected to criticize any deficiencies in these areas.

General Comment

The primary purpose of these examination procedures is to assure that the most senior policy-makers in the bank are aware of the need to follow sound banking policies with regard to the bank's international exposure and, in particular, to encourage diversifying exposure and avoiding large concentration of credit in potential problem areas. Consistent with the approach to bank supervision in the United States, placing a comment in the examination report should force officials of the bank responsible for its international activities to justify the exposure to senior management and, where appropriate, to the bank's board of directors. In such circumstances, management may reconsider the approach toward lending in that particular country.

If an examiner determines that the level of an exposure (relative to risk factors) is particularly high, or major problems exist elsewhere in international risk management, he may call attention to these findings in the summary of the examination and reference may be included in the letter transmitting the examination report. A bank's board of directors is required to review carefully all summary and transmittal comments.

Senator **Heinz**. I'd like to ask the Honorable C. T. Conover and the Honorable William M. Isaac to appear as a panel.

Gentlemen, we want to welcome both of you before the committee. We apologize that we've got to you a little later than we planned and anything you care to do to summarize your statements certainly will be welcome. Your full statements without objection will be part of the record. Let me first call on the Honorable C. T. Conover, the Comptroller of the Currency.

STATEMENT OF C. T. CONOVER, COMPTROLLER OF THE CURRENCY

Mr. **Conover**. Thank you, Mr. Chairman. I do have a lengthy statement that I would like to have submitted for the record and I will make a brief opening statement.

Mr. Chairman, members of the subcommittee, I am pleased to offer the views of the Office of the Comptroller of the Currency on the international financial situation, and in particular, the supervision of international banking. I will begin my remarks today with a brief description of the problems facing the U.S. banks and then discuss the possible actions to address those problems.

LOANS TO FOREIGN BORROWERS TOTAL $344 BILLION

As you know, U.S. banks today are major participants in the overseas markets. As of June 30, 1982, U.S. bank loans to foreign borrowers totaled some $344 billion. Loans to nonoil producing less developed countries, referred to as NLDC's, totaled $100 billion. Six NLDC's accounted for $75 billion of that amount. They were Mexico, Brazil, Argentina, South Korea, Chile, and the Philippines.

A number of debtor countries today have not completed the necessary adjustments to changed economic conditions and have temporarily lost their ability to enter the private capital markets even for routine financing. Of course, an attendant problem is that a number of our major commercial banks have large exposures to the countries that have become higher risks.

It seems to me that the solutions to these problems are two-fold. In the short term we must reduce the risk inherent in the existing exposures; that is, the borrowing countries must be restored to economic health. In the longer term we must address the banks' and supervisors' mechanisms for dealing with international lending.

The immediate debt problems can only be solved through the collective action of all the affected parties; multilateral institutions, Western governments, commercial banks and borrowing nations all have a role to play.

In this situation I support the financial assistance currently being provided. Multilateral institutions such as the Bank for International Settlements, the World Bank, and particularly the IMF have played essential roles. In addition to providing hard currencies upon which member nations may draw, IMF supported programs are also the basis for debt restructuring arrangements and for new private and official lending to countries with debt problems. It is therefore very important that the IMF continue to have the funds available to commit to adjustment programs for distressed nations. Given the Fund's existing commitments and the likely additional requests for its resources in the coming year, the proposed major increase in its quotas is essential. I strongly support that increase as well as the proposed changes in the general arrangements to borrow.

Western governments and central banks have provided a variety of direct financial assistance. Commercial banks which are the largest creditors of the NLDC's must also be a part of their debt restructuring programs.

In any loan workout situation, it is sometimes necessary to extend new credit to protect the lender's original investment. We recognize that banks, acting in concert with Western governments and multilateral institutions, may decide to reschedule existing loans and interbank placements in affected countries by advancing additional funds.

Over the longer term, lenders and supervisors must take additional steps to address the international lending problems. In the interest of time, I'll skip a description of the present supervisory system and how it works, which focuses basically on the means and purpose test and the role of the Interagency Country Exposure Review Committee and get right to the four possible actions that I believe deserve consideration.

POSSIBLE SOLUTIONS TO INTERNATIONAL LENDING PROBLEMS

As you will see, these actions are not significantly different from the ones proposed in your legislation.

The first is prudential reserves for problem loans. Some U.S. banks are not realistically recognizing the value of foreign loans with protracted repayment difficulties. We believe banks should adjust the value of such assets rather than carrying them on their books at full value. For that reason, we and the other bank regulatory agencies are considering whether to establish a reserve policy for a uniform treatment of such loans. Under such policy, special prudential reserves could be established for foreign loans on which the borrower has not regularly made interest payments or has not performed under rescheduling arrangments for a protracted period of time. The reserves could be established from bank income in an amount to be determined by the bank regulatory agencies each year.

The second would be changes in accounting for fee income. Neither generally accepted accounting principles nor regulatory reporting requirements now specify how loan fees should be recognized as income. For that reason, the banking agencies are exploring whether and how to require banks to more realistically recognize fee income.

Specifically, we believe that when loan agreements are long term and have resulted from a continuing relationship with the borrower, most of the fee generally represents an adjustment to interest yield. As such, these fees should be amortized over the life of the loan as traditional interest income rather than considered current income.

The third possible action would require better information and disclosure. To meet supervisory needs, the banking agencies are also considering whether banks should be required to report their transfer risks quarterly instead of semiannually. To help the money and capital markets, banks should also disclose additional data so there is information on the maturity structure of their foreign assets and the categories of their foreign borrowers such as public sector, private sector, and interbank.

All market participants need better information on the foreign exposure of other countries' banks and improved economic data on debtor countries. The new Institute of International Finance now being organized by the major international banks will help alleviate this problem by acting as a clearinghouse of data on international lending.

Fourth, I'd like to comment on the subject of country lending limits. The concept of putting a ceiling on a bank's total exposure in individual countries has been proposed as a simple, direct solution to current international lending difficulties. However, on balance, such limits appear to be neither practical nor desirable. Over the short term, it would be difficult to shift bank portfolios from today's composition to one that would conform to any meaningful limits.

Imposition of limits would almost certainly require sharp curtailment in overseas credit flows. Developed countries might find it necessary to replace this lost credit by pulling their loans and investments out of the United States. A curtailment of credit flows to the NLDC's could seriously impede their ability to generate sufficient economic growth to repay loans from U.S. banks or anyone else.

Philosophically, I find it difficult to justify absolute limits on transfer risks without at the same time limiting other concentrations of risks, including lending to particular domestic sectors or geographic regions. I would not favor such limits there either.

On balance, I believe it would be inappropriate to impose country lending limits on U.S. banks. We are, however, continuing to examine ways to achieve greater diversification in lending. As an alternative to formal lending limits, it may be possible to build additional protections into the special prudential reserves that I mentioned earlier. Rather than basing the required reserves only on considerations of risk, we may also wish to incorporate loan concentration as an additional criterion.

In effect, a bank could be required to increase its reserve and/or capital based on both concentration and risk. In concept, this approach could be applied to any type of concentration, domestic or international.

In conclusion, U.S. banks foreign loans present significant problems both to banks and to bank supervisors. However, I do believe these problems are manageable and I have outlined some of the proposals I believe would help us deal with this situation.

Ultimately, the condition of U.S. bank loans overseas is a function of the state of the worldwide economy. Today we have an international recession that has taken a heavier than expected toll on U.S. bank loan portfolios, both domestic and international. Our ultimate goal therefore must be to restore stable, noninflationary economic growth throughout the world and to maintain a free and open international trading and financial system.

Our efforts to improve bank supervision must be carried out within the context of that goal.

Thank you, Mr. Chairman.

[Complete statement follows:]

STATEMENT OF C. T. CONOVER
COMPTROLLER OF THE CURRENCY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
FEBRUARY 17, 1983

Mr. Chairman and members of the Subcommittee, I am pleased to offer the views of the Office of the Comptroller of the Currency on the international financial situation and, in particular, the supervision of international banking. My statement is divided into two parts. The first part describes commercial bank lending to the developing countries. The second part discusses current and proposed financial, supervisory and banking responses to the developing countries' debt problems.

I. BANK LENDING TO DEVELOPING COUNTRIES

U.S. commercial banks have been active in international finance since the early 1960's. Today, they are both major lenders and deposit takers in overseas markets. As of June 1982, U.S. bank loans, interbank deposits and acceptances to both foreign and domestic borrowers totaled $1.3 trillion. Roughly one-quarter of that amount, $344 billion, consisted of credit to foreign borrowers denominated in non-local currencies.

U.S. banks are active lenders in both the industrialized and developing countries. Fifty-seven percent of U.S. banks' loans overseas are to the industrialized countries. Loans to the non-oil producing less developed countries (NLDCs) account for 30 percent; seven percent are to oil producing LDCs that generally have low financing needs. Most of the remainder are credits to offshore banking centers (4 percent) and Eastern Europe (2 percent); Yugoslavia accounts for a major portion of loans to East European countries. (Chart 1)

Moreover, overall U.S. bank international exposure is diversified. U.S. bank exposures exceed $5 billion in each of 18 countries, all of which are important trading partners of the U.S. (Chart 2) The relative loan exposure to most of these countries roughly parallels their relative importance as U.S. trading partners.

Significant commercial bank lending to the NLDCs began with the first OPEC price increase in 1973 and grew rapidly thereafter. As of June 30, 1982, the NLDCs had external debt of $550 billion. Approximately one-half of this amount was owed to foreign commercial banks, of which $100 billion was owed to U.S banks.

Six NLDCs--Mexico, Brazil, South Korea, Argentina, Chile, and the Philippines -- have experienced rapid growth and have represented growing export markets for the U.S. economy. Exposure to the six NLDCs as of June of 1982 amounted to $75 billion, only 20 percent of U.S. bank international loans, or about six percent of total loans.

In each of these countries, U.S. bank loans account for no more than one-third of total external debt. Even in the case of Mexico, our close neighbor and third largest trading partner, non-U.S. commercial banks have loaned one-and-a-half times the amount loaned by U.S. banks. (Chart 3) Moreover, the

U.S. share of lending in Mexico and other Latin American countries has generally declined through the 1970's as non-U.S. banks moved into this growing market.

To understand the various reasons for the rapid increase in bank lending to the NLDCs, it is helpful to divide the last decade into two periods. The first period extends from the 1973-74 OPEC price increase up to the second OPEC price increase in 1979-80. The second period begins with the 1979-80 OPEC price increase and continues through today.

A. REASONS FOR INCREASED BANK LENDING TO NLDCS (1973-78)

Lending to the NLDCs by commercial banks in the industrialized countries grew rapidly for four reasons. First, the external financing needs of the non-oil developing countries increased significantly during this period. Three factors contributed to these increased needs:

- Rapid economic growth: The economies of the NLDCs were growing rapidly, and domestic savings, while high as a percentage of GNP, were insufficient to finance the capital investment required by their development plans.

- Rapid increase in the price of oil: The fourfold OPEC oil price rise of 1973-74, which increased the OPEC current account surplus from $7 billion in 1973 to $68 billion in 1974, resulted in a corresponding deterioration in the current account positions of all oil importing nations. Higher oil prices, in combination with the worldwide recession they fostered, combined to quadruple the NLDC current account deficit over two years, from $11 billion in 1973 to $46 billion in 1975. (Chart 4)

- Policy decisions to finance both economic growth and oil price increase: To avoid the economic dislocations that could result from a rapid adjustment to the oil shock, many oil importing countries, both industrialized and developing, decided to stretch out the adjustment process by financing the higher cost of oil. Low or negative real interest rates made this option particularly attractive. In the NLDCs, the need to finance the oil price increases was superimposed upon an on-going need to finance economic development. Much of this additional financing came from foreign sources, including banks.

The second reason for increased commercial bank lending was that the growth rate of financing needs in the more advanced NLDCs outpaced the growth of bilateral and multilateral assistance. Official lending agencies also shifted their concessionary financing toward the poorer LDCs. The larger and more creditworthy NLDCs thus relied more on private sources for their external financing. As a result, the share of these NLDCs' debt held by private lenders has increased over the last decade. (Chart 5)

Third, western governments had economic reasons to encourage commercial bank lending to the developing world. The heaviest borrowers generally represented large and growing markets for OECD exports. (The real rate of economic growth of the NLDCs since 1973 has consistently exceeded that of the United States and the OECD as a whole, as shown in Chart 6.) Increasing the level of external financing enabled NLDCs to continue to pursue economic development while, at the same time, providing growing export markets and jobs for industrialized countries. U.S. exports to the six major NLDCs rose from $7 billion in 1973 to almost $22 billion in 1979. (Chart 7)

Fourth, NLDCs represented new, growing, and profitable markets for commercial banks. Moreover, the need to recycle OPEC surpluses required the banks to provide an essential intermediation service between the OPEC countries with large volumes of funds to invest and the NLDCs with current account deficits. Bank lending was concentrated in those NLDCs believed to have high potential as markets for banking services and exports from industrialized countries.

Lending to these nations was initially profitable. Fees exceeded one percentage point, and most banks charged rates up to 200 basis points above the London Interbank Offered Rate (LIBOR). These fees and spreads seemed especially attractive since postwar international lending had led to few repayment problems.

However, the initial profitability of the NLDC markets did attract new lenders and resulted in two gradual changes. First, many smaller banks that were less sophisticated in international lending became participants, and second, competition contributed to a reduction in fees and spreads. By the end of the 1970's, many loans were being made at 75 basis points or less above LIBOR.

By 1978, it appeared that the challenge of the first oil shock had been met. Oil prices had stabilized, and the OPEC current account surplus was approaching zero. Economic growth in the West was entering its third year. With the help of international borrowing many parts of the developing world were experiencing economic growth above the levels of a decade earlier.

Nonetheless, the NLDCs were particularly vulnerable to future economic shocks. Their capacity for taking on additional debt was limited by previous heavy borrowings that would begin to mature in 1980-82 and would have to be rolled over. In addition, real interest rates had remained historically low throughout the mid-1970's; any increase would raise the cost of servicing existing and future debt.

B. LENDING TO NLDCS AFTER 1979-80 OIL PRICE INCREASE

In 1979, oil prices again began to increase sharply. By the end of 1980, OPEC oil prices exceeded $34 per barrel, a 160% increase over 1978 prices. Once again the world faced a fundamental decision: whether to inflate or to adjust. This time most industrial countries decided to make major adjustments in their monetary and fiscal policies.

As a result, the NLDCs faced a less favorable economic environment after the second oil price increase than after the first oil shock, and some did not begin their adjustment soon enough. Economic growth slowed in the industrial countries, thereby reducing demand and lowering prices for NLDC exports. The NLDC trade deficit, already hurt by higher oil prices, therefore began to increase. (Chart 8) The need to finance this widening trade deficit contributed to an increasingly rapid growth in NLDC debt; by 1980, NLDC debt had nearly quadrupled from the end of 1973. (Chart 9)

A large proportion of this debt had been made on non-concessionary, floating rate terms. As both nominal and real interest rates rose sharply (Chart 10) and medium-term debt from 1973-74 began to come due, debt service payments rose rapidly. Principal and interest payments increased from $69 billion in 1980 to $108 billion in 1982. (Chart 11)

The result was a rapid increase in the NLDCs' average debt service ratio during 1981. Debt service ratios for four of the six NLDCs that were major U.S. borrowers increased even more rapidly than the average. (Chart 12) Moreover, in addition to these rapidly increased debt service costs, NLDCs also had to finance current needs at a time when export earnings were stagnating.

Despite the deterioration in the financial condition of the NLDCs, commercial banks continued to increase their exposure to these countries in the expectation that the worldwide economic slump would be short-lived. Lending to the six major NLDCs increased by almost 30% per annum in 1980 and 1981 and rose an additional 10% during the first 6 months of 1982.

Conditions in each of the three largest borrowing NLDCs seemed to indicate that additional loans could be safely extended. In 1980, Brazil began to undertake its own severe monetary and fiscal adjustment program and sharply reduced its trade deficit. Argentina was able to maintain a balance of trade surplus until the Falklands War. Mexico's debt service capacity seemed to be rapidly growing as its proven oil reserves swelled at the very time that real oil prices were rapidly increasing.

Nonetheless, bankers did exhibit more caution during this period. Loan pricing became more cautious as spreads once again increased. Banks also began to sharply reduce the maturity of new loans -- in many cases to only one or two years. What appeared to be a cautious move by each individual bank, however, actually increased the instability of international markets in 1982 as many of these loans came due.

In 1982, a number of events combined to cause a major shift in market expectations about the creditworthiness of NLDCs. The general forecast of a relatively short recession in the West gave way to uncertainty about when recovery would occur. Expectations of rising oil prices gave way to growing perceptions of an oil glut. Deflation seemed suddenly more likely than continued inflation. Confidence in international lending was shaken by a number of shocks to the international credit and interbank markets, such as Poland, Penn Square, Drysdale, Banco Ambrosiano, and the Falklands War.

In the midst of this growing uncertainty, NLDCs were faced with the need to refinance a huge amount of debt -- both medium-term loans from the mid-1970s and short-term credits extended in 1980-81 -- and to gain new financing. In this uncertain environment, however, commercial banks became increasingly cautious about continued lending without some program to deal with the underlying NLDC economic problems.

This change both in perceptions and in reality became a problem in August of 1982 when Mexico announced that it could not meet debt service payments due that month. Argentina, with its exports curtailed and its finances disrupted by the Falklands War, reached the same situation shortly thereafter. Despite its considerable progress since 1980 toward fundamental adjustment, Brazil found itself caught up in the general uncertainty about lending to Latin America. It could not raise even relatively modest additional financing and, by December of 1982, began negotiations with the International Monetary Fund (IMF) and its commercial lenders. Within the space of four months, the three largest NLDC borrowers from U.S. banks were forced to seek rescheduling and assistance.

The basic problem we now face is that a number of debtor countries have not been able to adjust quickly enough to rapidly changing economic conditions, and are having difficulty in arranging new financing from the private capital markets.

An attendant problem is that a number of our major banks have large exposures to the countries that have become higher risks. More specifically, a number of U.S. banks have exposures exceeding 50 percent of capital to Mexico, Brazil, and/or Argentina. Losses resulting from the highly unlikely event of a total default by one of these countries would severely impact the capitalization of those banks. At a minimum, such a loss of capital would force those banks to greatly contract their lending activities -- domestic and foreign.

The loss of confidence that would result from a default would magnify these consequences. Unlike smaller banks, all large U.S. banks are heavily dependent for funds on the money markets; they do not have large core deposit bases. (Chart 13) As a group, these banks depend on volatile liabilities (less than one-year in maturity) for approximately 65 percent of their funding. (Chart 14) One common source of such funding is large certificates of deposit; some 40 percent of these funds have even shorter maturities of 30 days or less. (Chart 15) Thus, large banks are vulnerable to very rapid withdrawals of funds if financial markets lose confidence in them. Such a loss of funding could pose a serious threat to the banks and to both domestic and global credit markets.

II. RESPONSES TO NLDC DEBT PROBLEMS

The solutions to these problems are two-fold. In the short-term we must reduce the risk inherent in the existing exposures; that is, the large debtor countries must be restored to economic health. We cannot immediately reduce the exposure itself, for to do so would merely compound the economic problems faced by those countries. Both official and commercial bank responses, in the form of financial assistance, debt rescheduling and economic adjustment programs, are needed in order to accomplish this goal.

In the longer term, we must address the banks' and supervisors' mechanisms for dealing with international lending. The following sections discuss both the immediate reduction of risk through financial assistance and economic adjustment, and the avoidance of system-threatening risks through banker and supervisory responses.

A. FINANCIAL ASSISTANCE AND ECONOMIC ADJUSTMENTS

In discussing the NLDCs' debt problems, let me underscore three points. First, the current debt situation is largely the result of the sharp change in world economic conditions and expectations and a failure of some NLDCs to pursue adequate adjustment to that change. Second, the fundamental problems are of liquidity, not solvency. Third, the immediate debt problems can only be solved through collective action by all the affected parties: multilateral institutions, western governments, commercial banks, and borrower nations.

In this situation, I support the financial assistance currently being provided. This financing will:

- Give borrowers time to adjust their economies to today's harsh financial environment;
- Tide them over until economic recovery in the West improves their export earnings and thus their debt service capacity; and
- Strengthen confidence in the international credit markets after the overreactions in the last half of 1982.

This financing is being provided by multilateral institutions, western governments, and the commercial banks themselves.

Multilateral institutions, such as the Bank for International Settlements (BIS), the World Bank, and particularly the International Monetary Fund have played essential roles. Although its own resources are limited, the BIS has served as a focal point for the efforts of participating central banks.

The IMF provides hard currencies upon which member nations may draw. IMF supported programs are also the basis for debt restructuring arrangements and for new private and official lending to countries with debt problems. Each dollar of Fund resources can attract several additional dollars in private and official support for a borrower nation. It is therefore very important that the IMF continue to have funds available to commit to adjustment programs for distressed nations. Given the Fund's existing commitments and the likely additional demands upon its resources in the coming year, the proposed major increase in its quotas is essential. I strongly support such an increase.

It is also important that the Fund ensure its capacity to respond in crisis situations when its regular sources of financing may not be adequate. To this end, the proposed changes in the General Arrangements to Borrow are needed.

Western governments are providing a variety of direct financial assistance. In the United States, for example, we have extended agricultural and export credits as well as other direct financial assistance. Western central banks, including the Federal Reserve, have been important sources of bridge financing. These programs are vital to short-term liquidity needs and must continue.

Commercial banks, which are the largest creditors of the NLDCs, must be part of their debt restructuring programs. As bank supervisors, we are concerned about any significant exposures to distressed nations in an individual bank. However, we also realize that what may be prudent action for a single bank would be unwise for all. A comprehensive reduction of U.S. bank exposures to these nations would precipitate the very credit crisis we seek to avoid.

We therefore recognize that banks, acting in concert with western governments and the multilateral institutions, may have to reschedule existing loans and to advance additional funds to these borrower nations at this time. In any loan workout situation, it is sometimes necessary to extend new credit to protect the lender's original investment. The rescheduling of current maturities, the restoration of interbank placements with banks in the affected countries, and the provision of new funding are appropriate commercial bank components of a larger debt restructuring program to restore orderly debt repayments.

The collective financial assistance efforts now underway will restore liquidity and return confidence to international credit markets. These official assistance packages will also require borrowers to institute more discipline in managing their financial affairs. Over the long term, however, lenders and supervisors must take additional steps to address international lending problems.

B. SUPERVISORY AND BANK RESPONSE

Both bank supervisors and bankers themselves need to strengthen their procedures. In order to understand how that can be done, it is necessary to understand how our present supervisory system works.

Current Supervisory Process

The present system developed as a logical extension of our domestic supervisory policies and evolved as U.S. banks expanded their lending activities overseas. The CCC began examining the overseas units of national banks in 1965 and today sends about eighty examiners to fifteen countries every year. In 1972, we opened a London office to deal with the lending and money market activities of U.S. banks. In 1973, we began requiring all national banks to file reports of condition on a global consolidated basis. We began a uniform review of country risk in 1974. We implemented the present FFIEC country lending survey in 1977, along with more comprehensive examination policies and procedures for supervising international activities. Supervisors in other countries have adopted these procedures for use with their own banks.

In 1978, the OCC developed the so-called "means and purpose test" for applying lending limits to sovereign borrowers. In 1979, the three banking agencies established the Interagency Country Exposure Review Committee (ICERC) to evaluate transfer risk and incorporate that evaluation into bank supervision. These last two developments form integral parts of our international bank supervisory process today.

Means and Purpose Test. The means and purpose test was developed in light of continued growth in international lending. By 1978, loans to foreign governments, such as the U.K. and Italy, were nearly 10 percent of some banks' capital. That growth presented two problems. First, the statutory lending limit in 12 U.S.C. 84 was silent on loans to governments; hence, it was theoretically possible for U.S. banks to lend many times the single-borrower limit to a foreign government. Second, many countries had mixed economies in which the government controlled commercial entities. For such countries, it was not clear whether loans to those entities should be aggregated with loans to the government for purposes of the legal lending limit.

The OCC addressed both these problems by issuing an interpretation of 12 U.S.C. 84. First, OCC interpreted the law that a government is considered a person for lending limit purposes. Congress recently confirmed this interpretation in the Garn-St Germain Act.

Second, the interpretation set forth a means and purpose test that said that a state-owned company could qualify for its own lending limit apart from the government if it used the loan for its own clearly separate purposes and had independent means with which to repay the loan. Finally, as is the case domestically, the legal lending limit is applied separately to each private sector borrower in each country.

The result is that while the means and purpose test in 1978 closed a significant gap in the lending limit statute (the law's silence with regard to the treatment of sovereign borrowers), it did not impose an overall limit on exposures in any one country.

Both the legal lending limit and its means and purpose interpretation with regard to sovereign borrowers deal with the aggregation of loans. They do not deal with the evaluation of any particular source of risk to those loans, or the degree to which the bank's overall portfolio may be exposed to those risks. The interpretation reflects the domestic application of the legal lending limit. For example, the lending limit applies to individual agricultural borrowers. There is no limit on a bank's overall concentration in agricultural lending, however, and in many farming communities those concentrations directly and indirectly represent most of the assets in many community banks. Banks with such concentrations may be significantly threatened by the risk of illiquidity in their loans under depressed agricultural economic conditions, even though those loans may be secured by sound collateral.

Similarly, no aggregate limit is placed on country lending even though such lending exposes banks to a different form of liquidity risk, known as transfer risk. Transfer risk occurs when loans made in one country are denominated in the currency of another country -- that is, a country may not be able to generate adequate foreign exchange to permit the servicing of individual credits.

Interagency Country Exposure Review Committee. The Interagency Country Exposure Review Committee (ICERC) is the principal mechanism for assessing transfer risk and communicating that assessment to banks and examiners. ICERC is comprised of senior examiners from the three banking agencies; it performs two functions:

- Data gathering: ICERC conducts a semi-annual Country Lending Survey through the FFIEC to obtain information on U.S. bank exposure to individual countries. When exposures to individual countries change by billions of dollars quarterly, as occurred in 1982, semi-annual information forms an inadequate basis for credit decisions by banks and supervisory decisions by regulators.

- Transfer risk evaluation: ICERC evaluates the potential transfer risk in countries where U.S. banks lend. Evaluations are based on information from the Federal Reserve, Treasury Department, and U.S. banks. ICERC classifies loans when they become non-performing as the result of transfer risk. ICERC evaluations are sent to banks and examiners as a part of the examination process.

Bank examiners present ICERC's evaluation of transfer risk in their Reports of Examination to the bank's directors. The exposure is shown in dollar amounts and as a percentage of the bank's capital. Examiners also highlight large concentrations of transfer risk, even when the loans are still current. In 1981, we began emphasizing transfer risk classifications and concentrations as a specific agenda item during regular meetings with bank boards of directors.

Banks are expected to have their own policies and systems for evaluating risk and for diversifying assets in order to limit concentrations of risk. These policies are also appraised in the Report of Examination.

Proposals to Strengthen Supervision

U.S. bank supervisors and bankers themselves can and should take steps to strengthen lending procedures in order to reduce the future likelihood of accumulating large high risk exposures overseas. At least four possible actions deserve consideration. Two, which deal with reserves and fee income, could ensure that banks at least do not profit from difficulties that may arise and, in fact, may pay a penalty. Two others, which deal with better information and country lending limits, involve increased incentives or regulations to avoid excessive concentrations.

1. Prudential reserves for problem loans. Some U.S. banks are not realistically recognizing the value of foreign loans with protracted repayment difficulties. We believe banks

should adjust the value of such assets, rather than carrying them on their books at full value. For that reason, we and the other banking agencies are considering whether to establish a reserve policy for the uniform treatment of such loans.

Under such a policy, special prudential reserves could be established for loans on which the borrower has not made interest payments or has not performed under rescheduling arrangements over a protracted period of time. The reserve could be established from bank income in an amount to be determined by the bank regulatory agencies each year.

2. Changes in accounting for fee income. Fees received in conjunction with international credits, including reschedulings, typically represent both expense reimbursements and interest yield adjustments. However, when the loan agreements are long-term and have resulted from a continuing relationship with the borrower, most of the fee generally represents an adjustment of interest yield. As such, these fees should not be considered current income; they should be amortized over the loan period as additional interest income. The only portion of a fee that should be taken into current income should be those amounts that represent costs directly incurred in putting the loan together.

Neither generally accepted accounting principles nor regulatory reporting requirements specify how loan fees should be recognized as income. For that reason, the banking agencies are exploring whether and how to require banks to more realistically recognize fee income.

3. Better information and disclosure. To meet supervisory needs, the banking agencies are considering whether banks should be required to report their transfer risks quarterly instead of semi-annually. Although such reporting would impose an additional expense on banks and increase their paperwork burden, such information may be necessary for supervisors to better monitor bank exposures overseas.

The money and capital markets may also need more frequent and detailed information about international exposures, such as information on the maturity structure of foreign assets and categories of foreign borrowers (public sector, private sector, and interbank).

Finally, all market participants need better information on the foreign exposure of other countries' banks and improved economic data on debtor countries. The Institute of International Finance, currently being organized by the major international banks, will help alleviate this problem by acting as a clearinghouse of data on international lending.

4. Country lending limits. The concept of putting a ceiling on a bank's total exposure in individual countries has been proposed as a simple, direct solution to current international lending difficulties. However, absolute country lending limits appear to be neither a practical solution for immediate problems nor a desirable mechanism to deal with the problem of transfer risk over the long term. This is true for a number of reasons.

First, it would be very difficult to shift bank portfolios from today's composition to one that would conform to any meaningful limit. A basic decision would have to be made on how to set the limits. It would be politically and diplomatically difficult to set different limits for different countries. Therefore, we must assume that there would be one limit, probably based on bank capital, for every country. A number of major U.S. banks, however, have large exposures in one or more countries. Much of this credit has been extended to countries that are not experiencing economic difficulties. For example, a number of banks have exposures to Canada, Japan, the U.K. and other industrial countries well in excess of 100 percent of capital. Imposition of uniform country lending limits would require banks to reduce these exposures as well as those to more troubled borrowers.

The consequences of reduced credit flows to these countries, which include our allies and trading partners, clearly would be undesirable. These countries might find it necessary to replace this capital shortfall by pulling their loans and investments out of the United States.

A complete curtailment of future credit flows to the NLDCs, much less an absolute reduction in current exposures, would be no more desirable. Such action could seriously impede the ability of NLDCs to generate sufficient economic growth to repay loans from U.S. banks or anyone else.

It is difficult to justify absolute limits on transfer risk without at the same time limiting other concentrations of risk, including lending to particular domestic sectors or geographical regions. I would not favor those types of absolute limits either. On balance, then, I believe it would be inappropriate to impose country lending limits on U.S. banks.

We are, however, continuing to examine ways to achieve greater diversification in lending. As an alternative to formal country lending limits, it may be possible to expand upon the concept of prudential reserves discussed earlier. Instead of establishing required reserves based only on risk, we could incorporate loan concentrations as an additional reserving criterion. In effect, then, a bank would be required to strengthen its reserves and/or capital based on both concentration and risk. This strengthening could be mandated in such a way that required capital or reserves to increase as loan concentrations increase. Conceptually, this approach could be applied to any type of concentration, domestic or international. If such a system were devised, it might avoid the rigidity of lending limits while imposing considerably greater pressure to diversify loan portfolios.

CONCLUSION

U.S. banks' foreign loans present significant problems both to banks and to bank supervisors. However, I believe these problems are manageable.

It is not possible or desirable to make immediate reductions in U.S. banks' exposures overseas. To do so would cause an immediate credit contraction and precipitate the very crisis that we are all working to avoid.

Instead, what is needed is the extension of additional credits to meet the pressing needs of borrowing nations pending adjustment and the restoration of economic growth. These efforts have been coordinated and must continue to be carried out by all interested parties: multilateral institutions, western governments, banks, and the borrowers themselves. To that end, we strongly support the increase in IMF quotas and the GAB.

At the same time, we need to strengthen our supervisory procedures. We are seriously considering the following:

(1) improved information and disclosures about borrowers and international loans and more disclosure of U.S. banks' exposures overseas;

(2) changes in the accounting treatment of fees for international loans so that they are taken into income over the life of the loan; and

(3) special prudential reserves against credits with a history of protracted payment difficulties.

The feasibility of some sort of country lending limits also may warrant exploration, although I am not convinced they are an appropriate solution to this problem.

However, we must coordinate our efforts with those of bank supervisors in other countries. They are essential in any effort to strengthen the worldwide banking system of which U.S. banks are an integral part.

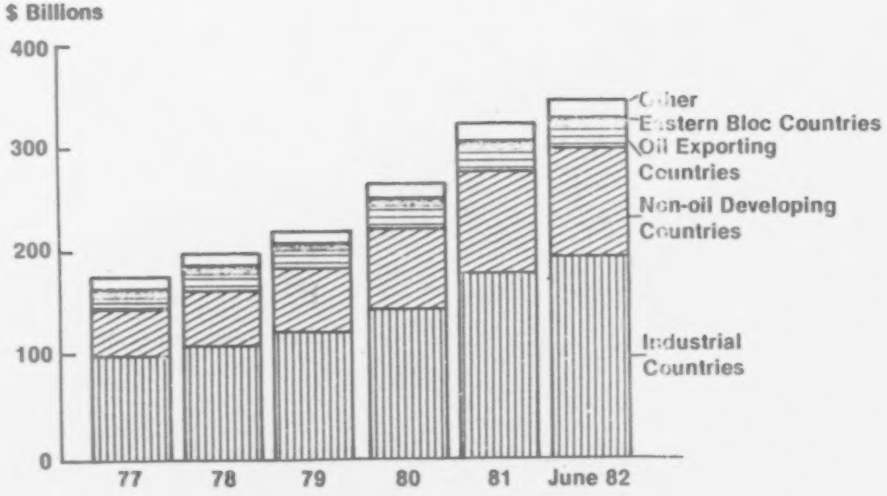
Ultimately, the condition of U.S. bank loans overseas is a function of the state of the worldwide economy. Banking is, by its very nature, the business of taking risks. Inevitably, there will be countries in the world that are experiencing economic difficulties, and U.S. loans to those countries will reflect those problems.

Today, we face a worldwide recession that has taken a heavier than expected toll on U.S. bank loan portfolios, both domestic and international. Our ultimate goal, therefore, must be to restore stable, non-inflationary economic growth throughout the world and to maintain a free and open international trading and financial system. Our efforts to improve bank supervision and those of our counterparts throughout the world must be carried out within the context of that goal.

# # # # # #

CHART 1

U.S. BANKS' INTERNATIONAL EXPOSURE

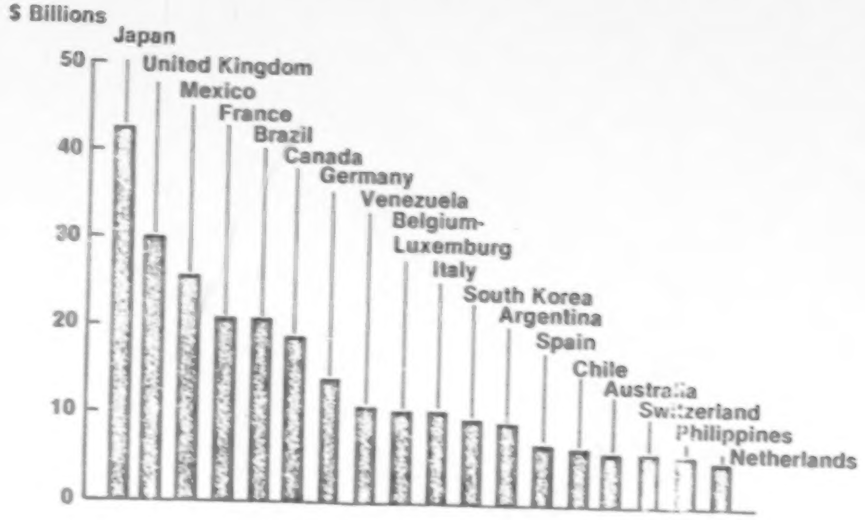


"Other" Includes Offshore Banking Centers and International Organizations

Source: FFIEC, "Country Exposure Lending Survey"

CHART 2

U.S. BANK EXPOSURE TO INDIVIDUAL COUNTRIES*

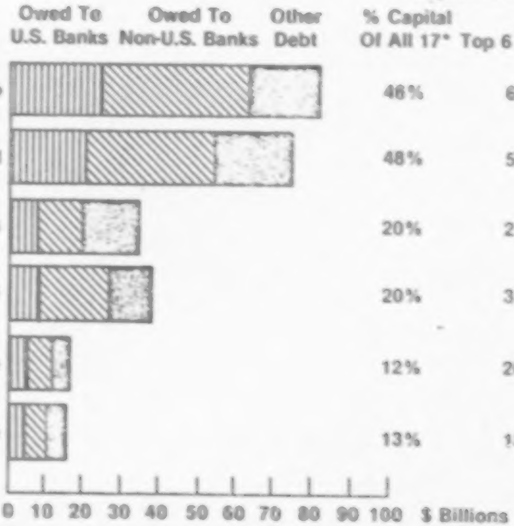


*Mid 1982, After Adjustments For Guarantees And Indirect Borrowings, But Excluding Commitments.

Source: FFIEC, "Country Exposure Lending Survey"

CHART 3

BANK EXPOSURE TO THESE DEVELOPING COUNTRIES IS LARGE



	Exposure of 17 Largest U.S. Banks		
Country	% Capital Of All 17*	Top 6 Banks**	Bottom 6 Banks***
Mexico	46%	60%	33%
Brazil	48%	53%	30%
S. Korea	20%	25%	12%
Argentina	20%	31%	12%
Chile	12%	20%	7%
Philippines	13%	18%	7%

*Combined June 1982 Exposure of All Seventeen Banks as a Percentage of Their Combined Capital. The Seventeen Banks Being Considered All Had Total Assets in Excess of $15 Billion on That Date.

**Average Exposure of the Six Banks with the Highest Percentage Exposure.

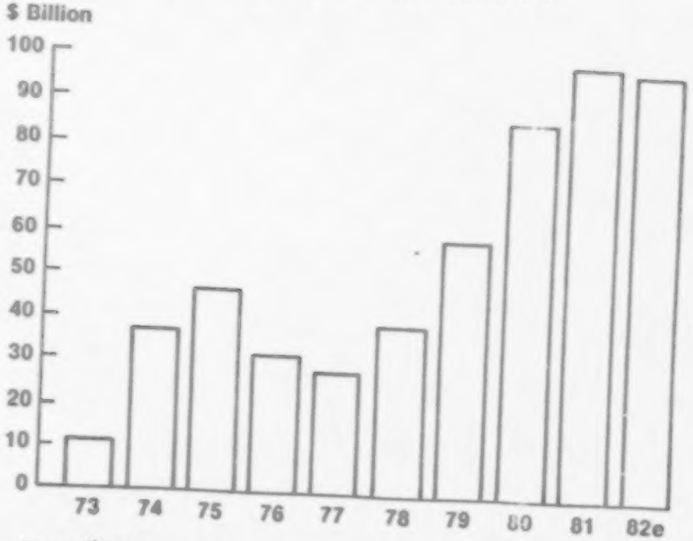
***Average Exposure of the Six Banks with the Lowest Percentage Exposure.

Sources: FFIEC, Department of Treasury

CHART 4

EXTERNAL DEFICITS HAVE INCREASED

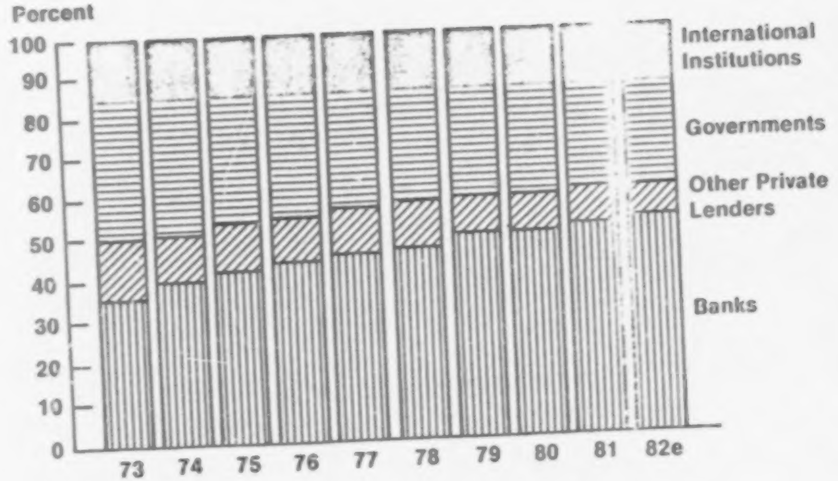
Current Account Deficits Of
Non-Oil Developing Countries



e = estimate
Source: IMF

CHART 5

DEBT OF NON-OIL DEVELOPING COUNTRIES BY TYPE OF LENDER

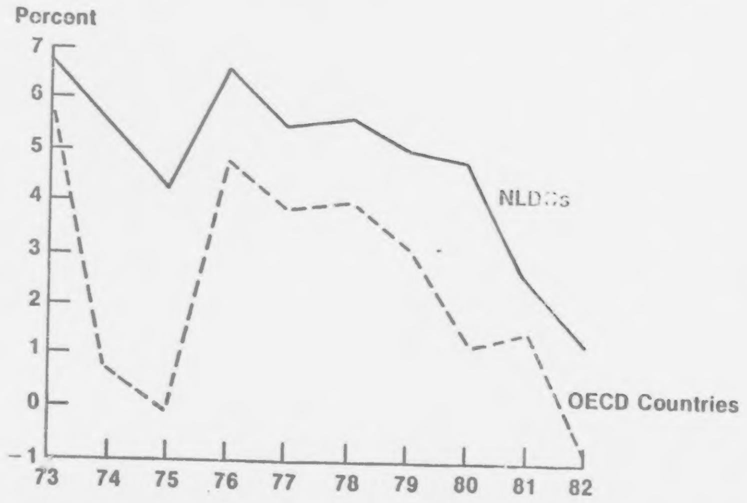


e = estimate
Source: IMF

CHART 6

NON-OIL DEVELOPING COUNTRIES HAVE GROWN FASTER THAN OECD

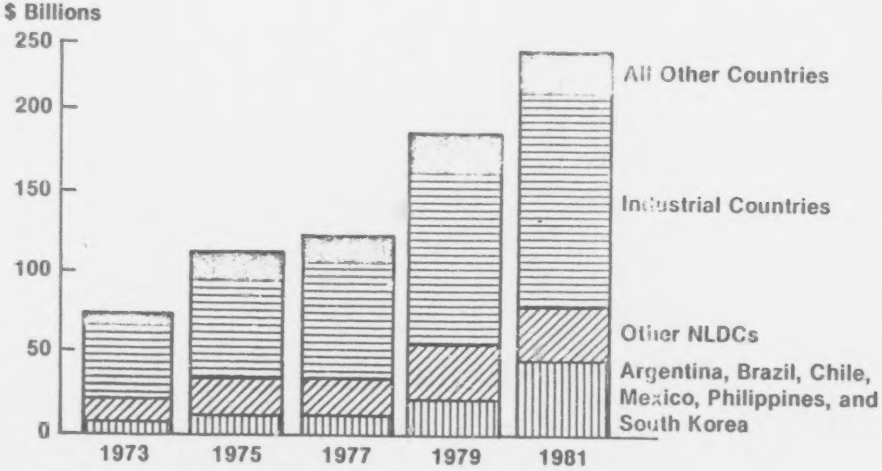
REAL GDP GROWTH RATES



1982 Growth Rates are Estimates.
Source: Federal Reserve

CHART 7

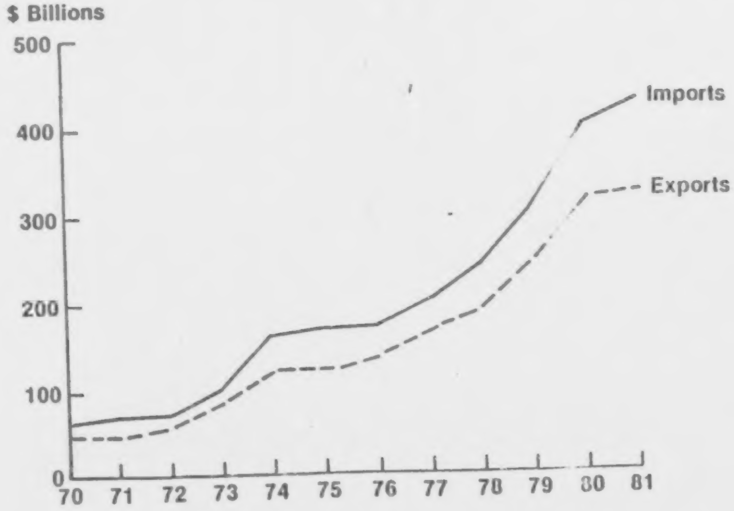
DESTINATION OF U.S. EXPORTS



Source: IMF

CHART 8

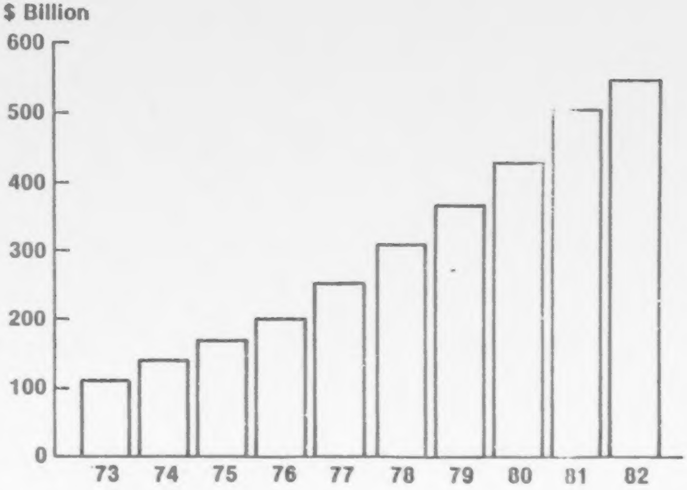
THE GAP BETWEEN IMPORTS AND EXPORTS HAS WIDENED FOR NON-OIL DEVELOPING COUNTRIES



Source: IMF

CHART 9

GROSS EXTERNAL DEBT OF NLDC's

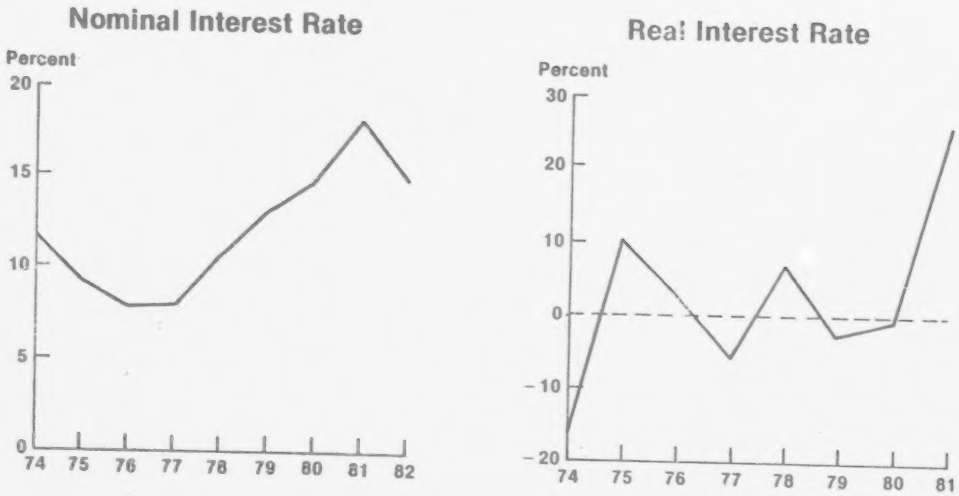


1982 Debt Figure is an Estimate.

Source: Federal Reserve

CHART 10

INTEREST RATES FACED BY NLDCs



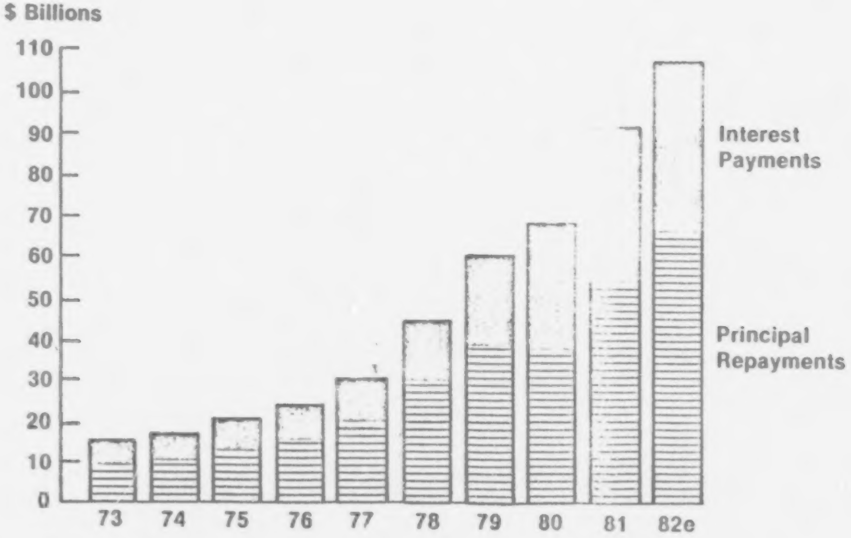
Nominal Interest Rate: 3-Month Eurodollar Rate plus Average Spread Faced by NLDCs.

Real Interest Rate: Nominal Interest Rate Deflated by Changes in NLDC Export Prices Denominated in Dollars.

Source: Federal Reserve, IBRD, IMF

CHART 11

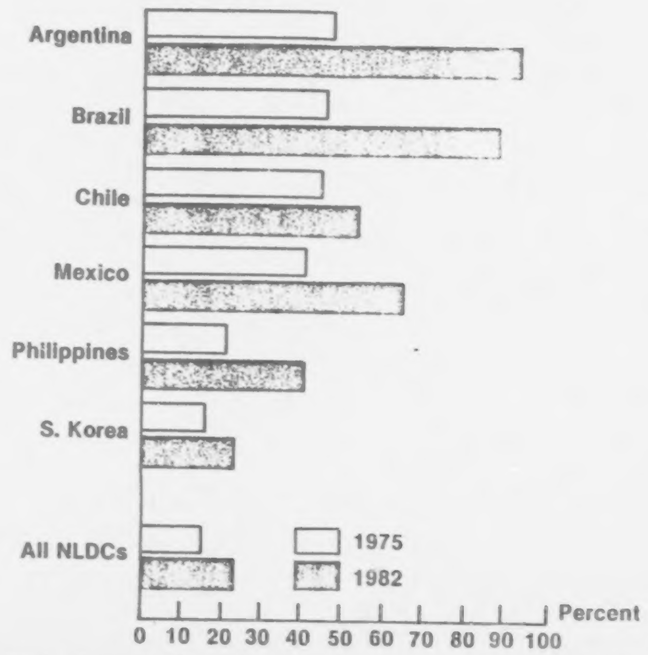
NLDC DEBT SERVICING PAYMENTS ON LONG-TERM EXTERNAL DEBT HAVE ALMOST QUADRUPLED IN FIVE YEARS



e = estimate
Source: IMF

CHART 12

DEBT SERVICE RATIOS* FOR SIX LARGE NLDC BORROWERS



*Debt Service Payments (Amortization of Long-term Debt plus Interest Payments on Short- and Long-term Debt) as a percent of Exports of Goods and Services.

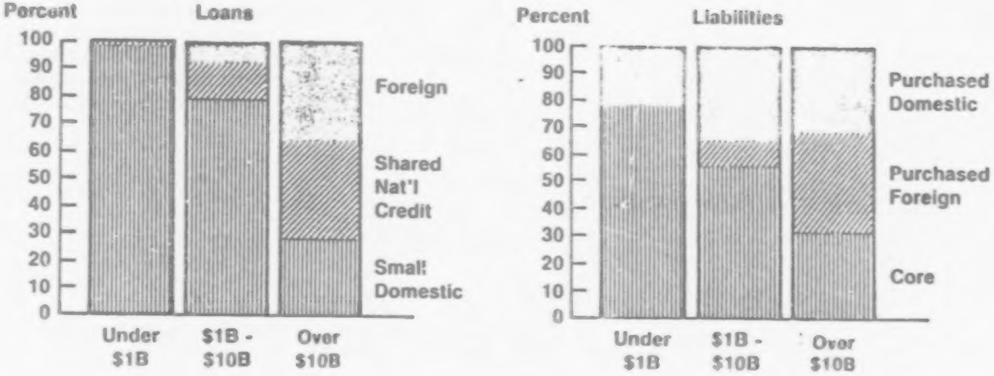
1982 Debt Service Ratios are Estimates.

Source: Federal Reserve Bank of New York, Department of Treasury

CHART 13

LARGE BANK BALANCE SHEETS DIFFER FROM SMALL ONES

- Foreign Loans
- Large National Credits
- Purchased Liabilities - Foreign and Domestic



As of 6/82

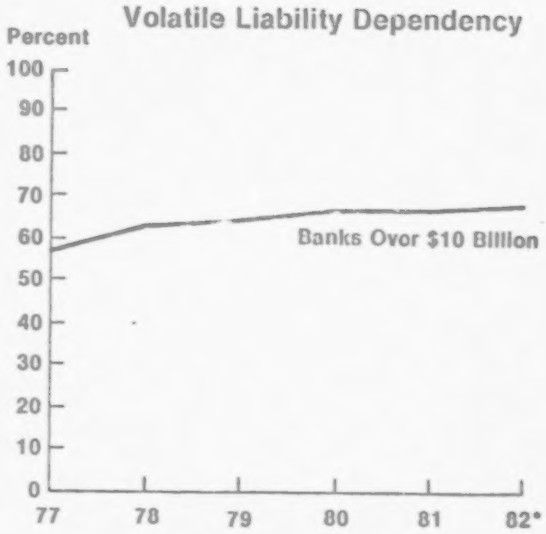
Source: Call Reports, Shared National Credit System

CHART 14

LARGE BANKS ARE HEAVILY DEPENDENT ON VOLATILE LIABILITIES

VOLATILE LIABILITY DEPENDENCE: Volatile liabilities less temporary investments divided by net loans plus lease financing receivables and investment securities with remaining maturities of more than 1 year.

VOLATILE LIABILITIES: The sum of all time deposits over $100 thousand, interest-bearing foreign office deposits, all other foreign office deposits, Federal funds purchased, securities sold under agreement to repurchase, interest-bearing demand notes issued to the U.S. Treasury, and other liabilities for borrowed money.

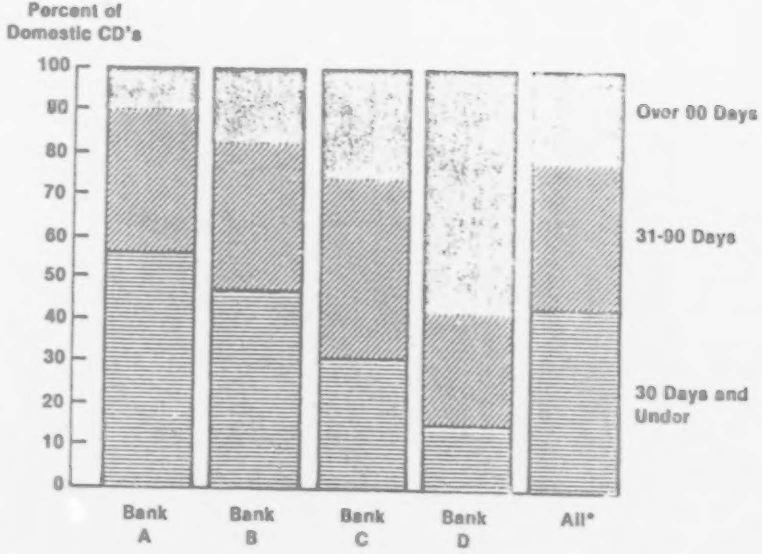


*Through 9/82.

Source: OCC

CHART 15

BANK DOMESTIC CD PORTFOLIOS ARE VERY SHORT



*Banks With $750 Million Or More In Total Assets
Data for 7/82

Source: OCC

Senator **Heinz**. Thank you, Mr. Conover.

Mr. Isaac.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. **Isaac**. Mr. Chairman, thank you. I want to first apologize for not having our testimony up here on time. We have been somewhat busy this week, as you are aware.

[Complete statement follows:]

STATEMENT ON

INTERNATIONAL AND DOMESTIC IMPLICATIONS OF U.S. COMMERCIAL LENDING TO FOREIGN GOVERNMENTS AND CORPORATIONS

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, I welcome this opportunity to present our views on the international financial situation. I will outline very briefly the nature of the global financial problems and their causes and then focus most of my remarks on remedial measures.

The Problem

Many developing countries have accumulated substantial indebtedness to the world's commercial banks. A number of those countries are having serious difficulties meeting repayment schedules. In many countries, public and private indebtedness to foreign banks has been or is in the process of being rescheduled.

A substantial portion of the indebtedness is owed to U.S. banks. The most recent figures indicate in excess of 35 percent of the developing countries' debt to commercial banks is held by U.S. banks, with the major share (over 20 percent) held by the large, multinational banks. For the larger borrowers, foreign debt and servicing requirements are very high relative to gross domestic product and export income. For example, the 1983 debt-servicing obligations of the four largest Latin American borrowers (Mexico, Brazil, Venezuela and Argentina) amount to about 120 percent of their projected export earnings. By any criteria, the situation is of concern.

In spite of the seriousness of the current global financial situation, we do not believe extreme pessimism is warranted. We may well be at the low point of both the domestic and international recession. An expanding world economy may cast many of today's world debt problems in a better light a few years from now. Moreover, the problems are now well recognized, and a dialogue among banks, creditor and debtor nations, and the international organizations has begun.

The Causes

While a number of factors are important in explaining how the current situation developed, they can be summarized as follows:

- Overly stimulative fiscal policies and accommodative monetary policies produced inflation in the U.S. and world economies over a sustained period and fueled the expectation of a continued rise in prices, particularly of commodities. The large oil price increases by OPEC exacerbated the situation for many nations.

- Banks saw opportunities for what appeared to be very profitable lending. Most credits were originated at a premium over LIBOR, overhead costs were low, and the default risk of lending to foreign governments and large foreign business firms was perceived by many banks to be minimal. Moreover, information concerning the financial condition of, and financing activities by, various nations was deficient, so banks were not always aware of just how much borrowing was occuring until after the fact.

- Banks were encouraged by many in their role as "recyclers" of OPEC surpluses to countries incurring payments deficits due to the large increases in oil prices. As a consequence, however, banks developed a significant credit exposure to the non-oil-producing developing countries.

- Bank regulators were insufficiently sensitive to the developing problems in foreign lending and failed to take firm steps to limit credit concentrations and the leveraging of bank capital.

These factors having set the stage, a combination of elements converted the potential problem into a reality. Depressed economic conditions throughout the world limited the growth in world trade and resulted in falling prices for primary products (the main exports of developing countries) instead of the continued rise upon which many lending decisions had been predicated. Oil-exporting developing nations, in particular, were placed in a precarious position relative to debt-servicing demands due to the decline in oil prices, a development that favorably affected oil-importing nations. Record high interest rates had an immediate, painful impact on borrowers because a large share of LDC lending was on a floating-rate basis. Finally, appreciation of the dollar raised the debt-servicing burden of countries with dollar-denominated debt.

It is difficult, and not particularly useful, to "blame" any group for the current international financial problems. There is plenty of blame to go around and the U.S. government must accept its share of it. In our judgment, however, it is far more important that we focus our attention on the steps that must be taken to relieve the present strains in the system and to decrease the possibility that similar problems will arise again.

In our opinion, the basic ingredient missing during the past decade has been "discipline." Governments throughout the world have not exercised discipline in the management of their financial affairs. Some banks may not have had much more discipline, but it would be difficult to make the case that they have had substantially less.

Possible Remedies

Short Term

The International Monetary Fund (IMF) can play an important role in stabilizing the present situation. The IMF is in a position to keep private and public lenders in line, to provide orderly expansion of credit where that seems appropriate and to insist upon the appropriate belt-tightening and other policy adjustments needed by debtor countries. It is extremely difficult, under the present circumstances, for private lenders to impose such discipline. Making additional resources available to the IMF, including raising the U.S. quota, would increase its ability to provide emergency funding to help bridge liquidity problems and to avert potentially serious international financial problems. Making additional funds available to IMF would not bail out or replace private debt; in the aggregate, the latter will increase. Banks will be required to stay in and be part of the solution. We support the proposal to increase the resources of the IMF because we believe it is a reasonable, balanced approach to resolving some difficult, immediate problems in the worldwide financial system. We are convinced, however, that this is only a short-term response and that more fundamental changes must also be made.

Longer Term

Some experts have questioned whether lending to foreign governments should be the responsibility of the private banking system. Others have suggested a statutory lending limit on loans to foreign countries. While it is understandable, under the circumstances, that these kinds of questions and solutions would be raised, we believe better long-term solutions are available. There is nothing inherently wrong with U.S. or other banks making loans to foreign countries. They do involve special risks which argue for even more caution and prudence than one would find necessary with respect to domestic lending. However, if the loans are for the purpose of supporting economically-sound endeavors and are likely to be repaid as agreed at market rates, they can be highly beneficial to the U.S. and world economies and should not be discouraged.

The question is: how do we insure that the loans will be economically-sound? We believe the answer is to allow the market system to function with as little government interference as possible.

We are firmly committed to the preservation of a strong, privately-owned banking system. The free-enterprise system cannot function properly unless there is discipline, and we cannot achieve or maintain discipline unless we permit market forces to operate -- to reward the successful and penalize the unsuccessful.

Unfortunately, the present system of bank regulation and insurance unwisely inhibits the operation of the market and creates the wrong kinds of incentives. We currently have the worst of two worlds.

During the 1930s, we crafted a tightly-controlled regulatory environment to protect banks from competition. Product, price and geographic competition were highly regulated through interest-rate controls, entry restrictions, limitations on permissible activities and branching restraints. Bank regulators were assigned the responsibility of preventing bank failures, almost at any cost.

A deposit insurance system was developed to help restore confidence and stability and to protect despositors in the event of failure. Although the deposit insurance system was originally designed to provide protection to only smaller, unsophisticated depositors, it has evolved into a system which is perceived by most people as providing full protection for all depositors and other creditors of our larger banks. Larger banks are perceived by most sophisticated creditors as being "failproof," at least in terms of depositors suffering a loss in the event of trouble. They believe we simply cannot and will not pay off the deposits of a large bank. They believe we will either prop up the bank with new capital or, at worst, merge it into another institution. In either case all depositors, insured and uninsured, would be made whole both as to principal and interest.

As a practical matter, the potential problems involved in paying off insured depositors in a large bank would be enormous. The administrative and logistical problems that would be involved in the FDIC's assuming control of a large bank, preparing checks for insured depositors and liquidating the bank's assets are difficult to even contemplate. Moreover, the uninsured deposits would be extremely large and would be tied up in a receivership for years, thereby causing substantial disruption throughout the economy. Finally, the franchise value of the institution would be lost, significantly increasing the cost of the failure to the FDIC.

For these reasons, a merger of a failed bank is ordinarily far superior to a deposit payoff. The problem is that under current law a merger cannot be accomplished without making all depositors and other general creditors whole.

The Congress has recognized the importance of this issue, particularly in a deregulated environment, and has requested the FDIC to present its recommendations for reform by April 15 of this year. I cannot tell you at this time precisely what our recommendations will be, but I can say that we will almost certainly recommend that we be given the authority to arrange for the merger of a failed bank on a basis that does not make all general creditors whole. This may be the single most important reform that could be made to restore discipline in our banking system and insure that it will remain strong under private ownership.

We are not so naive as to place all of our faith in the market. During our first 150 years as a nation, we had a significant amount of unfavorable experience with an unregulated, uninsured banking system. We believe in deposit insurance, and we believe regulation and bank examinations are vitally important.

We are convinced, however, that particularly as interest rate controls and other restrictions on competition are eliminated, we must find new ways to control destructive competition and excessive risk-taking.

We could attempt to achieve that objective by hiring thousands of additional bank examiners and adopting countless new regulations. Such a system would be expensive, would stifle innovation and undermine many of the benefits we hope to gain from deregulation, and, ultimately, would probably not be effective in controlling the level of risk in the system.

We would like to supplement our supervisory system by bringing market forces into play to a greater degree. We must gradually, and in a non-disruptive fashion, move away from the notion that all large-bank liabilities have a federal guarantee behind them.

Disclosure

If the marketplace is to function effectively in controlling bank risk, it must be given sufficient information about the nature of that risk to make an informed decision. The banking agencies have adopted new call report schedules to provide information on non-performing loans, interest-rate sensitivity and asset/liability maturity structures, and we will make this information public this year beginning with the June 30 report. That is a step in the right direction, but more needs to be done.

The Securities and Exchange Commission recently broadened disclosure requirements for bank holding companies with respect to loans outstanding in countries experiencing liquidity difficulties. It may be desirable to to require banks to routinely report their loan exposures on a country-by-country basis, whether or not liquidity problems exist.

Special Reserves

If disclosure is to be effective, it must properly reflect conditions in the bank. If losses exist, they ought to be reflected.

Many banks have acted responsibly and provided specific reserves to reflect foreign loans at a realistic carrying value. Others have not. We believe that when severe and protracted problems warrant, banks should specifically reserve against certain loans. By requiring banks to reserve against these assets, earnings statements and capital accounts will be more realistic and dividend policies more disciplined.

In this same vein, we are also reviewing the accounting treatment of fees paid to banks at the time a loan is rescheduled. In some cases it appears these fees are being taken into earnings immediately. A more realistic approach would have the fees taken into income over the life of the restructured credit or perhaps even charged directly against principal. The agencies are currently reviewing this issue.

Conclusion

In conclusion, we believe the problems in the worldwide financial system, which have been developing over the past decade or so, are serious but manageable if the countries and bankers involved act responsibly. We believe this is occurring, as evidenced by the IMF proposal which we support.

In our judgment, it would be unfair and a serious mistake to attempt to assess the entire responsibility for the current situation against the banking industry. Bankers have been overly aggressive in some instances and mistakes have been made. They are by no means alone. The basic climate in which they were operating was created by government policies throughout the world. We cannot expect to maintain the banking system on a sound basis indefinitely unless we pursue sound economic policies throughout the major nations of the world.

The financial system is undergoing a virtual revolution. On the international side, banks have been operating for more than a decade on a major scale in a fast-paced, deregulated climate. Deregulation is rapidly becoming a fact of life on the domestic side as well.

Our regulatory and insurance systems were not designed to deal with the financial system as we know it today. In our judgment, the regulatory and insurance systems are not consistent with a deregulated banking environment and no amount of tinkering will make it so; they are in need of a major overhaul and the sooner they receive it the better.

I appreciate this opportunity to present our views and will be pleased to respond to any questions.

Senator HEINZ. I thank both of you. You have come forward with some very specific proposals in many respects and some suggestions for sweeping proposals, Mr. Isaac, in your case. I'm going to start with you because you're really picking up where I left off with Mr. Volcker about the kind of incentives we have in the system or non-incentives for the system to get better, and I tend to agree with you that there really are not penalties here for people who don't do a good job. Indeed, there seems to be rewards rather than penalties.

One of the keys to making the system you describe work; however, it would require a very different way of evaluating non-performing loans than currently exists.

Do we have the ability to do this?

Mr. ISAAC. I think when you're dealing with a country defining a non-performing loan is much more difficult than when you're dealing with a company, but I think we have the ability to make a better assessment. We have taken steps to improve our procedures in this area.

Senator HEINZ. What would be the key elements in making that kind of improved assessment?

Mr. ISAAC. Courage.

Senator HEINZ. In addition to the basics, how about the technicalities?

IMPROVEMENT IN INFORMATION SYSTEMS NEEDED

Mr. ISAAC. We need better information systems and I believe those are being developed.

Senator HEINZ. Is there any reason why, as part of such an information system, we shouldn't require quarterly reporting by the banks rather than just leave it up to the judgment of you regulators?

Mr. ISAAC. Require quarterly reporting?

Senator HEINZ. Require quarterly reporting on the international aspects of their loans? Right now it's only semi-annual. The most recent information we have comes form June of last year.

Mr. ISAAC. I think quarterly reporting would be desirable and we could either have that in legislation or the regulators could simply require it.

Senator HEINZ. Now, Mr. Conover, you actually mentioned quarterly reporting. Is there any?

Mr. CONOVER. None at all. Here we are sitting in mid-February looking at June 30 data. It seems rather ridiculous to me.

Senator HEINZ. Might we speed your efforts if we simply said to you—you think it's a great idea and you want to do it, but why don't we tell you to do it?

Mr. CONOVER. That's just fine, sure.

Senator HEINZ. Chairman Volcker in previous occasions said he's not sure it may not be cost effective, but you don't share his doubts about it?

Mr. CONOVER. No, we don't. I suspect there will be lots of comments from the banking industry as to its costs. The Paperwork Reduction Act will be brought up. Quarterly reporting will not be accomplished without some dissent.

Mr. **Isaac**. Mr. Chairman, perhaps you could in this legislation exempt this requirement from the Paperwork Reduction Act so we don't have to deal with that issue.

Senator **Heinz**. We may want to exempt you from OMB's requirements of it in this particular instance.

Let's get back to the issue in the case of the Comptroller now of a system to look at what we will lump into this huge category of non-performing loans overseas that we do now. When Chairman Volcker was here he said, "Well, we have this list put together by an interagency process in which you participate." We have three categories: very strong, pretty strong and not so strong, weak, in other words. How much finer can we be on that? How much more rapidly can we put creditor countries on that list and I suppose, most important of all, what do you propose as a means of attracting the banks' attention to the fact that they are on that list?

Senator Proxmire pointed out that in the case of Mexico, after Mexico was on that list, there was an increase in the amount of money loaned by U.S. banks to Mexico, indeed, a very odd situation took place during the last year for which we have information—this was in Chairman Volcker's testimony—where during the last year's report in 1981 to 1982, there was about a $10 billion increase in loans to a small group of non-OPEC LDC's in the Western hemisphere, and whereas the traditional U.S. share of those loans had been about a third, it jumped to over half of the $10 billion we picked up about $6, and the question is, we seem to have been—doesn't that suggest to you that we were about the last to get the message and if that was so, why was that; and what could we do about it?

Mr. **Conover**. It may be that the banks were the last to get the message, but classifying a country as weak—as Chairman Volcker indicated, the countries are classified as strong, moderately strong, weak—need not be the triggering event for a bank management to decide that it does not want to extend further credit into that country, be it private sector or public sector credit or interbank credit. It merely puts a bank management on notice that we think the conditions in that country have changed and that they need to take a hard look at that situation before deciding what it is they want to do.

DISCLOSURE OF INDIVIDUAL BANKS EXPOSURE

Obviously, in the case that we're talking about, those who took a hard look at it concluded that it was better to continue to loan than to cut off loaning.

Senator **Heinz**. Mr. Isaac, Chairman Volcker seems to disagree with a lot of your suggestions. When Senator Riegle asked him about the disclosure of individual banks exposures, he seemed to be very reluctant to go on record as favoring any such thing. You believe that it's absolutely essential for individual banks to disclose the extent of their exposure in individual countries; is that not right?

Mr. **Isaac**. That is correct.

Senator HEINZ. And you're recommending to us that we require the SEC to expand upon what they have already done; is that the thrust?

Mr. ISAAC. I'm not sure that the SEC is necessarily the format. That might be one area—that's one mechanism.

Senator HEINZ. What are the arguments as you see them, even though you don't agree with them, against requiring individual banks to disclose their exposures in individual countries?

Mr. ISAAC. I suspect that there may be some sensitivity in those countries in terms of disclosing their borrowing from U.S. banks and the banks may have some trade reasons for wanting to keep information confidential. I haven't heard any reasons on the other side of it that outweigh, in my judgment, the importance of this information to the public, to the analysts, and to the banking regulators.

Senator HEINZ. Mr. Conover, do you agree with Mr. Isaac's suggestion with regard to disclosure?

Mr. CONOVER. Yes, I do. I think we are on the same wavelength on that. I think the arguments against disclosure that are usually put forth are that the information will be misunderstood or that it will provide a competitive advantage to somebody else. I would also agree that I don't think those arguments against disclosure outweigh the benefits of having better information and requiring it to be disclosed.

Senator HEINZ. Now, in moving toward a loan loss reserve system for nonperforming loans, we have been told on many occasions that you can't get there too quickly because it would discourage the participation by banks in the refinancing of these debts. Do you agree with that?

Mr. CONOVER. Yes, I do. The banking agencies have been discussing how a special prudential reserve would work among themselves and with selected bankers for at least 6 months. There has been a general feeling that we ought to be deliberate on the subject so as not to cause the bankers to cut and run, and not participate in the additional loans, for example, to Mexico.

Senator HEINZ. How quickly do you think that you corporately, the bank regulators, can develop such a system?

Mr. CONOVER. I think we are pretty close to having the technical aspects ironed out. I think it gets down to the question of timing as to when one ought to implement it. I would think this spring would be an appropriate time.

Senator HEINZ. So if we enacted legislation telling you to do this within 180 days, you could do it?

Mr. CONOVER. That would be no problem.

Senator HEINZ. Now we have learned that over 1,100 American banks were involved in this Mexico loan and is it not a regulation that banks, even if they're part of a syndicate, have adequate information in their files to assess the quality of any particular loan? Is that not true?

Mr. CONOVER. Yes, it is.

Senator HEINZ. Now, in your judgment, was that kind of information made available to your regional and small banks?

Mr. CONOVER. Well, it was a surprise to us, as it was to many, that there were 1,100 banks involved. The reports that come in on exposure to foreign countries are only made where the amounts exceed $20 million and, of course, most syndicate banks would be of that size. There are a large number of banks in border States—California, Arizona, New Mexico, Texas, the obvious ones—that have been doing business in Mexico with individual private borrowers for many, many years that really wouldn't be in any position to assess country risk in the broad sense. They were just doing business with a customer they had been doing business with for a long, long time.

Senator HEINZ. What can you do about this problem?

Mr. CONOVER. Well, one thing to do about it would be to extend the reporting requirement below the $20 million, but there comes a point at which you get the figure down so low that it does become a much greater burden on the smaller bank and it really isn't worth it.

Mr. ISAAC. Mr. Chairman, if I might add——

Senator HEINZ. You may, but are you saying you think it should be reduced below $20 million?

Mr. CONOVER. No. I don't see any need to—no.

Mr. ISAAC. There are banks that are involved in international lending that don't belong there, in direct response to your question. There are banks that don't have the personnel to develop the kind of information they need to properly assess the risks involved.

Senator HEINZ. You're talking about banks that are originating these loans?

Mr. ISAAC. Participating primarily. There are banks that are involved in this business that don't belong there and where we find that in our examination process we usually try to get them out. If we find that they don't have adequate information in their files or don't have the personnel to properly monitor the situation in these countries, then we try to get them out.

Senator HEINZ. Let's take the specific here where we know with some certainty there are 1,100 banks in Mexico. Of that 1,100, how many shouldn't have been there?

Mr. ISAAC. I don't know.

Senator HEINZ. Ten or a hundred?

Mr. ISAAC. There would have to be some.

Senator HEINZ. Clearly. But is it a relative handful or a fairly large armful, more like a dozen or maybe as much as 10 or 20 percent, several hundred banks?

Mr. ISAAC. I really don't know. A lot of those banks are probably border banks that naturally would do business in Mexico and I wouldn't have any problem with that. I think you would really have to go through and analyze which banks were doing what.

Senator HEINZ. Thank you very much. My time has expired. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Chairman Isaac, I'm delighted to see you today. We've had a lot of contact over the last few days.

Senator Proxmire noted in his opening statement that banks in the United States have increased their exposure in Mexico during 1982 by $3.8 billion and that's an annual rate of increase, as I understand, of their exposure in Mexico of 21 percent.

My question to you is, did the FDIC have knowledge of this increase and, if so, did you confer with the banks in question regarding the danger of the increase in loans going to Mexico?

Mr. ISAAC. I believe the answer would be "no" to both questions. One of the problems is that we get this information after it occurs. You can speed up the reporting process, but I don't believe we'll ever get it before it occurs.

CLASSIFICATION OF LOANS

Senator SASSER. Well, looking at the volume and type of loans that have been made by large banks to the less developed countries in the last 2 or 3 years, has the FDIC analyzed these loans as to their quality and, if they have, how have they been classified?

Mr. ISAAC. The loans to developing countries?

Senator SASSER. Yes, Mexico, Argentina, Brazil. Has your agency had an opportunity to review those and analyze them?

Mr. ISAAC. Those are reviewed by the interagency group.

Senator SASSER. How do you classify them?

Mr. ISAAC. Which one?

Senator SASSER. Have you made a classification of any of these loans as you do with domestic loans?

Mr. ISAAC. Yes.

Senator SASSER. The auditors will say, that's a good loan or a poor loan or a marginal loan, and I'm just curious as to how these loans have been classified, if they have been classified, with regard to some of these developing countries.

Mr. ISAAC. The various loans are rated either strong, moderately strong, weak; and then you go into substandard or below.

Senator SASSER. Can you give the committee any idea of the percentage of the loans that will be rated as substandard?

Mr. ISAAC. Small.

Senator SASSER. A small percentage. Less than 10 percent?

Mr. ISAAC. I would rather not give you a specific number at this time.

Senator SASSER. You said in your statement that——

Senator RIEGLE. Would you just yield at that point for a clarification? When you said substandard in your response, do you mean anything from substandard on down?

Mr. ISAAC. I assumed that was the question, substandard on down.

Senator RIEGLE. And when you said 10 percent, do you mean 10 percent of the loans or 10 percent of the aggregate value of the loans?

Mr. ISAAC. I'm sorry?

Senator RIEGLE. When the question was whether it was more or less than 10 percent, would that be 10 percent of the numerical number of absolute loans or would that be 10 percent of the aggregate value of all loans made?

Mr. ISAAC. I assumed we were talking values, not number of loans.

Senator RIEGLE. Thank you.

Mr. ISAAC. But that was not my 10 percent number.

Senator SASSER. In your statement, Mr. Isaac—I want to compliment you for the brevity of it—you indicate that on the international side banks have been operated for more than a decade on a major scale in a fast-paced deregulated climate. This deregulated climate, I would say, has probably contributed significantly to the dilemma that we find ourselves in. Wouldn't you agree with that? Or maybe you might like to amplify it?

NEED FOR MARKET DISCIPLINE

Mr. ISAAC. I don't think you can adequately control this banking system unless you change the insurance system to bring about a greater degree of market discipline. We need help.

Senator SASSER. You need more information, I gather.

Mr. ISAAC. We need more information and we need more marketplace discipline and I don't believe you can give this job in its entirety to the regulators and ask them to do it. I don't think it can be done.

Senator SASSER. Our problem here, as I'm sure you can well understand, the feeling here is that we weren't in on the takeoff of this and now that it looks like we might have a crash landing or are in danger of one, we've got to pump some more money in the International Monetary Fund. As one member of this committee, I would like to have more information from time to time so that on down the line we won't be confronted with this same problem again. I think it is essentially a Hobson's choice for us. We are in the position of being damned if we do and damned if we don't.

We run the risk of major banks in this country failing and you have outlined what a horror that would be for the FDIC to try to handle under present law. It would be an economic nightmare, both, I think, nationally and internationally. If we go forward and pump up the IMF in an effort to try to pull these banks back into line and perhaps save them to some extent—they're having to use funds at a time when we desperately need them here at home, at a time when that action would not be received sympathetically, to say the least, by most of our constituents; and we are urging on these countries a policy of limiting imports, to limit the imports from the United States which we also desperately need to promote during this period of time.

Well, I started to ask a question, Mr. Chairman, and I'm afraid I made a speech here, but the thrust of my comments is that I think we need more information in the future if the regulatory agencies are going to have to come here and argue in favor of putting more funds into the IMF. We need to know what's happening at least contemporaneously with some of it. That's my speech.

Mr. ISAAC. If it makes you feel any better, Senator, my first reaction—and it took me some time to get over it— to the IMF proposal was negative, the same as yours.

Senator SASSER. Then you started thinking about what happens if one of the large banks fails?

Mr. ISAAC. That's not the major concern I have. I believe we have an international financial situation that has gotten to the point where something needs to be done to take care of it in the short term and I think the proposed IMF solution is reasonable and balanced. It's probably the least disruptive approach we could take to resolve the problem. It's not the only possible approach, but it's a reasonable approach and probably the least disruptive one. I think we ought to go ahead and get it done.

I'm more concerned about making sure this problem doesn't come back again.

Senator SASSER. So am I. Thank you.

Senator HEINZ. Senator Hecht.

STOP DIVIDEND POLICIES

Senator HECHT. Mr. Isaac, when it was obvious that the exposure of these loans could jeopardize the capital of banks, why did you not step in and recommend that the banks stop dividend policies?

Mr. ISAAC. I don't think it was obvious in more than a couple small situations that the loans were loss loans. If we were to determine that there were losses in the loan portfolio, then we would intend to impose special reserve requirements which would affect dividends in these institutions. I don't think we can just step in and say "you're not going to pay dividends" until and unless we are able to make a determination that there are losses in the loans.

Senator HECHT. Carrying this further, if the IMF is granted the money. These loans could still be in jeopardy. Would you recommend that these banks stop paying dividends to boost their reserves?

Mr. ISAAC. We would recommend that any losses in their portfolios be recognized and taken and, thus, that would cut into their ability to pay dividends, yes.

Senator HECHT. In other words, right now we realize the exposure is astronomical compared to their capital. Why are you not asking them at the moment to stop paying dividends?

Mr. ISAAC. Well, every bank every time it makes a loan of any sort has exposure to loss, but you only make the bank recognize that loss and reduce its dividends or raise more capital when you have identified that loss as a probability, and that has not been done in the case of at least the major countries.

Senator HECHT. Well, as of now, you're telling us that there is a possibility.

Mr. ISAAC. Any time you make a loan there's a possibility that somebody might not repay it.

Senator HECHT. That's not a rational analysis. We are putting Mexico down there with all these loans. We realize the exposure. Why should the banks now not start taking precautions and start building up their reserves?

Mr. ISAAC. The banks might choose to take some precautions and build their reserves, but the regulators cannot require that unless they have determined that there is a likelihood of loss there and at this point we have not done that.

Senator HECHT. I have never in the past seen the FDIC so timid because I have been in situations where they have stepped in and recommended very strongly in these situations, but you don't feel the present situation warrants that?

Mr. ISAAC. Once the interagency committee reviews a country and determines that there is a likelihood of loss, then, if this proposal we're putting together on an interagency basis goes forward, we will require reserving.

Senator HECHT. Thank you.

Senator HEINZ. Thank you, Senator Hecht. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

First of all, I'd like to commend you, Chairman Heinz, for the leadership you're giving on this issue and the way these hearings have been developed. I think it's very important work and I think it's being done and led in a very fine way.

Senator HEINZ. Thank you.

Senator RIEGLE. It seems to me the more we get into this, the more it becomes clear that in order to take this step of authorizing this major new commitment to the IMF, the more obvious it is to me that we need some corresponding changes in our practices and procedures on how these loans are made by private banks both to countries and to private borrowers in foreign countries.

I, for one, have supported the need to stabilize the international financial situation with the IMF action being part of that stabilization effort, I don't think we should end consideration until we have clearly identified these additional safeguards that Senator Heinz and Senator Proxmire are working on and which I understand both agencies represented here are also working on. So when I read, for example, in your statement, Mr. Conover, about the proposals that are under consideration here—you listed a number of items—prudent reserves, problem loans, changes in accounting for fee income, better information and disclosure, country lending limits—I think we need to get through the analysis, judgment and decision process and have all of that nailed down before we make any final steps on the IMF contribution. I think they have to be done together and in one package and I don't think it would be acceptable to go forward without that.

So I just hope that the banks themselves would be cooperative and I mean highly cooperative, if they want to see this thing go ahead, in facilitating our coming to grips with this problem once and for all.

Senator HEINZ. If the Senator would yield, Senator Dole would like to cooperate in another way on an issue called withholding. By the time this bill moves—and I agree with you on the first part of what you're saying, we want to watch out. Senator Dole was so mad at the banks that he would like to do about 10 things to them, but I think maybe we should decouple and just deal with these kind of preventive measures.

Senator RIEGLE. Well, I think the chairman makes a good point and we are not talking here about adding extraneous items in terms of our discussion here in this committee, these are directly relevant items. They go to the issue of how did we get into this situation in the first place and how do we get out of it in an orderly process and stay out of it in the future.

And so I think it's essential that these things be connected in this legislation and that we have new safeguards to get this job done.

Now, Chairman Isaac, in your statement you make this comment: "It may be desirable to require banks to routinely report their loan exposures on a country by country basis whether or not liquidity problems exist." And I'm just wondering what is the best way, in your view, for this kind of reporting to take place?

For example, under SEC rules, there are certain disclosure requirements so that people who might be thinking about buying stock in a given company would have enough information to make a judgment about whether that was a prudent investment.

So one way we might do this is we might think in terms of requirements under the SEC that there be a full disclosure of loan patterns like this that could bear on the question of prudence of a financial decision. We could also approach it in terms of actual changes in written law which you might want to recommend to us or we might want to develop here. We could do it perhaps through some new regulatory mechanism which you folks would feel was appropriate to develop. But I'm wondering what would be your reaction to any of those and what do you have in mind here as perhaps the best way to get this information collected, get it out into the light of day, so that it's available for everybody to consider?

Mr. **Isaac**. I think that the SEC approach is one that will be desirable, but I would also think the bank regulatory agencies would also want it coming in directly to them in some form.

Mr. **Conover**. Senator, I think we have the semiannual reporting process requiring that banks report their country exposure now. I think a few modifications to the existing requirement, for example, by having it submitted on a quarterly basis, would provide us with what we need.

Senator **Riegle**. Are both of you planning to make formal recommendations to the committee of precise steps that you think ought to be taken to deal with this problem of disclosure and monitoring and going beyond the list of four items that you, Mr. Conover, suggested? Will you be giving us formal recommendations?

Mr. **Conover**. I'd be happy to do that.

Senator **Riegle**. Mr. Isaac?

Mr. **Isaac**. Yes.

Senator **Riegle**. Could you do that soon enough so that we could have that available to us before we go through committee markup and actually see this legislation move through to the floor?

Mr. **Conover**. Yes; we expect to do that.

Mr. **Isaac**. Yes.

Senator **Heinz**. If the Senator would yield to me for a comment, the chairman has absolutely no intention of proceeding to a markup until we have agreed upon the necessary legislation of the kind to which you refer.

Senator **Riegle**. Well, I'm pleased to hear that and I had expected that that was the chairman's view.

I may have other questions for you of a specific sort and if I do I will submit those for the record. I appreciate your testimony.

Senator **Heinz**. Thank you very much, Senator Riegle.

BANK LENDING LIMITS

I have just one or two final questions. Regarding exposure limits for banks in individual countries, which neither of you have been tremendously enthusiastic about for the reasons described, we do have, however, as I understand our current regulation, a means and purposes test which allows or restricts banks to lending no more than 15 percent of their capital to a separate borrower. Isn't that correct?

Mr. CONOVER. That's correct.

Senator HEINZ. Now if that's appropriate in the United States, why isn't some analogue of that appropriate overseas?

Mr. CONOVER. Let me, if I may, give you a very quick overview of exactly how it works in the United States and how the means and purposes test is applied overseas.

The existing 10-percent lending limit applies to any single borrower in the United States with few exceptions that we needn't dwell on.

Back in 1978, the Comptroller's Office issued an interpretation of the lending limit which basically said that a foreign government is to be considered a person for purposes of that 10-percent limit. Incidentally, Congress incorporated this interpertation into the Garn-St Germain Act.

Senator HEINZ. Isn't that why we aren't overexposed in Poland?

Mr. CONOVER. No; it is not.

Senator HEINZ. It is not?

Mr. CONOVER. A problem arises when there are government-owned or quasi-government-owned companies in some of these countries, particularly those countries that have mixed economies. So the question is how do you apply the lending limit against these quasi-governmental entities. The conclusion that was reached at the time was that if the entity had a separate, clearly identifiable purpose for its loan process and a separate means of repayment, such as would be the case of a government-owned railroad or a utility or a petroleum company, then for purposes of the lending limit test those loans would not be aggregated with loans to the sovereign government itself.

Senator HEINZ. We all recognize, however, that there's a fallacy there because even though they may have separate means of repayment in most of these countries they have to go through their central bank to get the currency with which to repay.

Mr. CONOVER. That is correct. Those tests do not apply to the issue of transfer risks which is what we are really concerned about here.

Senator HEINZ. And you're not opposed totally, as I understand it, to the concept of a limitation on transfer risks, but you have some reservations about it?

Mr. CONOVER. Well, I am concerned about the practicalities of it. For example, let's say that the goal were to establish a single limit for all countries. That means the same one that would apply to Mexico, Brazil, Argentina, and other NLDC's would also apply to such countries as Japan and the United Kingdom to which the banks have larger exposures than to Brazil, Mexico, and Argentina.

Senator HEINZ. By the way, that is not what our bill does, you realize.

Mr. CONOVER. I understand that. The alternative would be to establish different lending or exposure limits for different countries. I see that very quickly becoming, perhaps, the most important decision made having to do with the economic relationships between the United States and each of those countries. Unfortunately, I see it therefore becoming highly politicized as the process of establishing limits is developed and implemented.

Senator HEINZ. Let me ask you this. In effect, though, do we not have in effect with Poland right now, for all practical purposes, a limitation on any one bank not being allowed to lend more than 15 percent of its capital to Poland because there's only one party there.

Mr. CONOVER. We do in the case of Poland because, as far as I know there is no instance where the means and purpose test would be applied. As a matter of fact, our exposure in Poland is very modest.

NONPERFORMING LOANS

Senator HEINZ. I'd like to go back to the question of loan loss reserves and nonperforming loans. There are two countries that come to mind as being among the extreme when it comes to nonperforming, Zaire and Poland. With respect to the latter, it is my understanding that four German banks last year did not pay a dividend because of nonperforming Polish loans. Is that correct or not?

Mr. CONOVER. I can't confirm that, Mr. Chairman, but we do know that the German banks did in fact either pass or reduce their dividends last year because of domestic and/or international loan problems.

Senator HEINZ. Now as I understand it, Zaire is a little worse off than Poland. Wouldn't you agree?

Mr. CONOVER. Yes, I would.

Senator HEINZ. And they have been more nonperforming than Poland for a long time, maybe since 1978. Isn't that right?

Mr. CONOVER. I think so, yes.

Senator HEINZ. And we have had a number of our financial institutions tied up in there for quite a while. At what point under our current system, if there is one, would you ever recognize that some form of nonperformance appear on a balance sheet or income statement? And I gather that the answer is that under our present system we would have to wait about 250 years or more.

Mr. CONOVER. Well, under our present system, the loan could be written off if it were designated under the interagency committee system as a loss. We have been reluctant to designate countries as losses and for that reason we have been working on a system by which we would establish a special prudential reserve and then require banks to——

Senator HEINZ. Just so your answer is clear—I know I understand your answer but to be sure everybody else does—what you're saying is you never write a country off as a loss? We have never done it in the 200 years we have been a Republic as I understand it, or that was the testimony of Don Regan on Monday, and the only reason you don't is that creditors in a sense always want to have an opportunity to go and present a claim to whatever government it is, whatever that government says about whether or not they are going to repay you. So that just doesn't happen. You don't consider countries losses because they continue to exist. They don't go out of business the way a corporation can or the way an individual can under a bankruptcy proceeding and kind of somehow reemerge with a new identity.

Mr. CONOVER. Yes, that's correct.

Senator HEINZ. So the answer to my question in brief is, under the current system, it's virtually impossible for a regulator ever to require a bank to recognize nonperformance on the income statement and on the balance sheet; isn't that right?

Mr. CONOVER. That's correct.

Senator HEINZ. I wasn't driving at any deeper point than that.

Mr. CONOVER. The new system that we are proposing is intended precisely to overcome that weakness.

Senator HEINZ. I understand. One last question. Earlier today I referred to the testimony we got from Mr. Martin Mayer regarding the entry into the Federal funds market of countries like Mexico and Brazil. Chairman Volcker seemed to take that with equanimity. It didn't seem to bother him too much that countries were coming in here to finance their problems in the Federal funds market.

Do you think that's—he didn't like it, but he didn't seem too concerned about it. Do you view that with alarm or just mild disdain?

Mr. CONOVER. Well, I don't think I'd use either term. I think that——

Senator HEINZ. Or you just think it's illegal?

Mr. CONOVER. No, I don't think it's illegal because I think foreign agencies and branches who operate, for example, in New York City have the right like any other bank to operate in the Federal funds market. I do agree if they are using the Federal funds market on the one side of the balance sheet to in fact fund their balances of payments on the other, than that is an abuse, if you like, of the Federal funds facility.

Senator HEINZ. What should we do about it?

Mr. CONOVER. I'm not sure. I think we ought to take a look at it and see what the alternatives are. I don't have a ready answer to that, Senator.

Senator HEINZ. How soon could you take a look at it and give us your best answer?

Mr. CONOVER. Why don't we work it out with your staff with the understanding that we'll do it just as soon as we can?

Mr. ISAAC. I would just say that with respect to branches of foreign banks who apply for FDIC insurance, we have applied a limit of 25 percent of assets that can go to any one country as a condition of getting insurance.

Senator HEINZ. You have imposed that as a condition for getting insurance? Is that a requirement of the International Banking Act?

Mr. ISAAC. No. It's a requirement of the FDIC as a condition of obtaining FDIC insurance.

Senator HEINZ. Very well. Thank you very much. If there are no further questions, let me thank both of you gentlemen. You have given us some extremely valuable suggestions and we appreciate it. Thank you.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

NAM
National Association of Manufacturers

LAWRENCE A. FOX
Vice President and Manager
International Economic Affairs Department

February 24, 1983

The Honorable John Heinz
United States Senate
Washington, D.C. 20510

Dear Senator Heinz:

The decision made by your Subcommittee to hold hearings on International Financial Issues, in particular on the proposed increase in the International Monetary Fund (IMF) quota, was welcomed by us, at the National Association of Manufacturers. The issue of global debt has come to the fore at a time of great economic and financial strain. We are confronted with a prolonged worldwide recession, characterized by growing unemployment, spreading protectionism, several devaluations, sharp declines in commodity prices and a contraction in the volume of world trade.

The present global economic environment has seriously strained the debt servicing capacities of the developing countries, especially those in Latin America. The manner in which the international community responds--either with inward looking and excessively nationalistic policies or with cooperation and coordination--will ultimately determine whether the present situation deteriorates or improves. This, in turn, will have direct bearing on the chances for a sustained economic recovery in the United States. All members of the international community have a responsibility to play an appropriate role in assisting world economic recovery. One way in which the U.S. can carry out its role in overcoming present difficulties is by helping to increase the IMF quota by 47.4% from its current $66.8 billion to $98.5 billion. This would entail increasing the present U.S. membership quota of $13.7 billion by $5.8 billion.

The importance and necessity of increasing the IMF quotas, from the standpoint of the world economies as well as the U.S. economy, can best be understood in the context of increased world economic interdependence. The integration of the world economy was greatly accelerated in the 1970s by the rapid escalation in oil prices and the rise in the LDC debt occasioned by oil price increases. Despite the high levels of growth achieved by some developing countries during this time, the non-oil developing countries have faced adverse external environments for nearly a decade. They have experienced recurring recession or slow growth, poorer export earnings in world markets, declining terms of trade, high nominal and real interest rates and rapidly rising energy costs. For those countries which, nonetheless, sought to maintain industrialization and economic development, it was

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necessary to borrow abroad. Many of them did, on an unprecedented level, which left many of the non-oil developing countries with an enormous debt. From 1973 to 1982 the quantities of debt of these countries increased from about $100 billion to about $500 billion. As the global recession continues, some of the borrowers may be pushed to the edge of default.

Since the United States is the hub of the integrated world economy, it is only natural that U.S. banking and trading facilities have played a role in recent developments. Currently, however, U.S. commercial and governmental institutions alone are not sufficient to safeguard U.S. interests in the world economy. Under the present circumstances of a world economy under strain, it is appropriate that international institutions, such as the IMF, assume a larger role in easing that economic strain.

A brief glance at some of the U.S. interests in the world economy which would be aided by constructive action by the IMF indicates the validity of strengthening the Fund.

The risks developing from the payments problems of the LDCs do not just involve those countries on the verge of default and the lenders who face large loan losses. The interrelatedness of world markets spreads the impact of those problems to our economy and to the economies of the rest of the industrialized world. The most harmful effect of the current debt and liquidity problem is the possible worsening of the current economic contraction. Developing countries which are facing liquidity problems do not have the means to import. As individual nations restrict their economic activity, the world economy becomes static. In the United States, for example, much of the growth in trade in the past decade reflects an increase in exports and imports with developing countries.

Trade with Latin America is especially important to the United States. Thus we are particularly affected by the serious debt problem in our own hemisphere. Brazil and Mexico, in particular, have been very heavy borrowers. A look at our bilateral trade balance with Mexico illustrates the serious effects such a debt problem can have on the U.S. economy. In 1980 the U.S. had a manufactured trade surplus with Mexico of $7 billion. This surplus increased to $10 billion in 1981 as Mexico's oil revenues allowed it to purchase more from the U.S. In 1982, however, the trade surplus dropped to $5 billion due, in major part, to Mexico's debt servicing problems which necessarily curtailed the purchase of many imports from the U.S. Such a drop in U.S. exports has a serious dampening effect on the U.S. economy, an effect which we can ill-afford to ignore. It has been predicted by the Administration that because of the developing countries' debt problems, this year's U.S. trade deficit will be $10 billion to $20 billion larger than in 1982. This translates into a loss of about 0.5% in U.S. GNP.

As illustrated above, U.S. exports to developing countries are, and will continue to be, a crucial element in the recovery of the U.S. economy. However, the competitiveness of those exports in developing country markets depends largely on the financing which buyers of those goods can receive. Taking into consideration the importance of competitive financing, it is our view that adding punitive and overly restrictive requirements on U.S. banks lending in those countries would be counter productive. Such unduly restricted lending policies would result in higher interest rates which would, in turn, make U.S. goods less competitive in the affected markets and would, furthermore, increase the already heavy debt service burden on developing countries.

Private banks alone, however, cannot deal sufficiently with the debt difficulties in developing countries. The IMF, on the other hand, is one of the few existing institutions that can accommodate the adjustment process of countries such as Mexico. Conditionality can insure that credit is allocated properly, and it can promote a strengthening of the world economy. In Mexico, for example, the conditions of an IMF loan require that in one year the Mexican Government reduce a deficit that currently equals 16 percent of gross domestic product to a deficit of 8 percent. Such an effort requires a major reversal of Mexican fiscal policies, and this could materially help to salvage and ultimately to restore the Mexican economy to good health.

The IMF is helping to meet the needs of Mexico and of Brazil, and is struggling to aid developing countries around the world. Unfortunately, current IMF resources are not equal to meeting the credit needs of the LDCs. It has committed most of its $65.9 billion fund, and it is expected to face a shortfall by next year. The IMF quota has simply failed to keep pace with a growing demand on its resources. In the past decade alone, world trade has increased six fold, in terms of dollars, far outpacing the growth in IMF funding. As a result the 47.4% increase requested for this year is, in effect, a modest and very reasonable request.

Furthermore, the increase in the U.S. contribution to the IMF quota does not entail a direct call on the U.S. budget. Under U.S. budgetary and accounting procedures, the increase is treated as a "transfer of assets" rather than an "outlay" and so will not increase the federal budget deficit.

In addition, the U.S. contribution to the IMF quota is only a standby commitment. It involves cash advances only when and if demands on the IMF exceed the amounts that can be provided from current resources. Should the IMF call upon the U.S. commitment, there is an equal and offsetting debit and credit to the appropriation account, as the cash transferred to the IMF is reflected in an increased U.S. reserve position in the Fund. That reserve position is freely available to the U.S. in time of foreign exchange need.

In light of the important role the IMF could play in alleviating the strains on the world economy, warding off the difficulties which could be caused by developing countries' debt repudiation seems to be a prudent step. Considering the stake the U.S. has in improved prospects for the world economy and particularly the needs of Latin America, I urge you to support the proposal for increasing the IMF quota. The results will be beneficial to the U.S. economy, and the costs, budgetary and otherwise, will be very small.

I would greatly appreciate it if you could make this letter a part of the record of the Committee's hearings.

Sincerely,

Lawrence A Fox

Lawrence A. Fox

Statement by the
NATIONAL ASSOCIATION OF REALTORS®
regarding the U.S. contribution
to the International Monetary Fund
March 1983

by Dr. Jack Carlson
Executive Vice President and Chief Economist

Summary

The NATIONAL ASSOCIATION OF REALTORS® supports the Administration's request that the Congress authorize appropriations totalling $8.4 billion to fund an expansion of the lending resources of the International Monetary Fund (IMF).

We believe the economic consequences of a major international loan default would be disastrous for our economy. It would reduce private bank lending and lead to a major loss of confidence in the world financial system. Interest rates would then rise, stifling the tentative recovery of the real estate industry that is essential to renewed economic growth.

Without an increase in the IMF's hard currency lending resources, we believe such an international loan default could occur. Those lending resources are nearing exhaustion, yet continued IMF participation in efforts to alleviate the international debt situation is essential.

We recognize that, as the additional U.S. contribution to the IMF is drawn down, this will raise the federal government borrowing requirement. However, on balance, we believe that interest rates will be lower than they would have been had the U.S. failed to increase its contribution to the IMF.

Whether the proposed increase in IMF resources is a "bail-out" or a "bail-in" for the banks is, in our view, irrelevant. The main issue is which course of action will promote world economic stability and U.S. economic expansion. In our view, this is to approve the proposed increase in the U.S. contribution.

Extent of the International Debt Problem

It is estimated that the total volume of international debt owed by the non-OPEC developing countries now exceeds $550 billion. The largest debtors are Brazil ($85 billion), Mexico ($80 billion) and Argentina ($40 billion). Some 40 percent of the debt is held by private banks, the largest portion—in excess of $130 billion—by U.S. banks.

The scale of the international debt problem, relative to the resources currently available to deal with it, raises the specter of a default by one or more major international debtors. This would have a disastrous effect on the stability of the international financial system and on the U.S. economy. An effective means of avoiding this occurrence, therefore, must be found.

Causes of the International Debt Problem

Some critics of the current international debt situation argue that it is basically the fault of speculative lender banks and borrowing countries. Therefore, it is argued, they should be made to pay the price of their investment judgments, regardless of the consequences for the world economy.

Even if this argument was relevant to finding a cure for the problem (which it is not), it is almost invariably overstated. As a percentage of exports and GDP, the long term debt of the non-oil developing countries has increased over the last ten years but not dramatically (see Table 1).

Table 1

Long-term External Debt of Non-oil Developing Countries Relative to Exports and to GDP

	1973	1975	1977	1979	1981	1982
Ratio of external debt to exports	88.7	97.7	104.9	101.9	103.2	109.1
Ratio of external debt to GDP	16.6	18.3	22.1	22.7	24.3	25.2

Source: International Monetary Fund.

Moreover, recent international debt repayment problems are the result of high interest rates (caused by a combination of excessive government borrowing and tight monetary policy in the developed countries), not increased borrowing (see Table 2).

Table 2
Outstanding Debt and Interest Costs of the Non-Oil Developing Countries

	1970-73	1973-78	1978-80	1981	1982 (est.)
Outstanding debt (annual percentage change)	17	23	17	16	17
Average interest cost	5	6	8	10	11

Source: OECD, "External Debt of Developing Countries, 1982 Survey," December 1982.

The rapid acceleration of interest rates occurred in the aftermath of the second world oil price shock, at a time of world recession, when all countries were struggling to make a painful economic adjustment and accommodate domestic pressures for faster income growth. It is, therefore, very hard to accuse the developing countries of profligate borrowing in the past five years. It is also not difficult to understand why many private banks were willing to approve some additional lending to help these countries maintain essential imports and meet their debt payment obligations.

The Present Situation and its Potential Implications for Housing

More relevant than the causes of the problem is the issue of what should be done now.

Its potential implications for U.S. credit markets and indeed for the international financial system as a whole are clear. A default by one major debtor would result in a multi-billion dollar loss of lenders' capital. This in turn would result in a cumulative reduction in lending, both domestically and internationally, of between 15 and 20 times the initial capital write-off.

The immediate impact on real estate and other interest sensitive U.S. industries of such an event would be disastrous. A major decline in the demand for other interest-sensitive products, such as automobiles and household durables would also result.

Our economic recovery could be slowed and perhaps even stopped by the first-round effects of such an event. These could be accompanied by a worldwide loss of confidence in the financial system, a rise in international interest rates and a further contraction in domestic and export demand, which together would affect the standard of living worldwide.

A developing country government that sees no possibility of meeting its debt obligations without draconian and politically fatal retrenchments at home could be tempted to default in a desperate gamble for survival. Therefore, unless a successful method of assisting those developing countries with severe debt payment problems can be found, the prospect of such a major debt default is a real one.

Options for Action

One option is not to pump any additional hard currency lending resources into the international system. This has the superficial attraction of forcing the major debtors to adjust more rapidly to existing economic circumstances and placing responsibility for financing the adjustment process primarily on the shoulders of private lenders.

However, the adequacy of such a response is seriously open to doubt. Most analysts question the scope for further accelerating the process of adjustment in many developing countries. They have already suffered a major slowdown in economic growth over the past two to three years. Further retrenchment would threaten their economic and political stability and result in a decline in import demand, thus exacerbating the world recession.

Total reliance on private lending to tide over those countries with severe debt repayment problems is probably unrealistic also. Lenders' awareness of the reduced repayment capabilities of most developing countries has already resulted in a net reduction of private international lending, particularly by smaller banks. This is evidenced by the difficulty and cost of putting together the private lending component of the recent Brazilian and Mexican debt agreements.

Reasons for Supporting an Increase in IMF Resources

As a result of accelerated demand for assistance from the IMF, its hard currency lending resources are now down to less than $15 billion. Its ability to support and encourage continued private sector lending is, therefore, severely limited. If continued support from the IMF is needed, it can only come from an expansion of IMF resources.

After careful review, the members of the IMF have agreed to a 47.4 percent increase in national quotas from $66 billion to $99 billion, and a $12 billion enlargement of the General Arrangements to Borrow. The additional U.S. contribution would amount to $8.4 billion in total. Because only part of the additional quota contributions will be in lendable currencies, the package would boost the IMF's lendable resources by only some $28 billion.

In our view, this is a modest and much needed increase in the Fund's lending capability.

We recognize that, as those funds are required by the IMF, the Treasury must borrow in the financial markets to finance the U.S. contribution. In a situation where government borrowing is already excessive, this addition to the borrowing requirement is unwelcome. However, we consider the marginal impact it will have on domestic interest rates to be much less damaging to the recovery of housing and the economy than the alternative of a possible major international loan default.

We therefore urge you to support the Administration's request to authorize consent to and appropriations for an increase in the United States quota in the International Monetary Fund and to authorize appropriations for increased U.S. participation in the IMF's General Arrangements to Borrow.

NDPC
National
Democratic
Policy
Committee

Lyndon H. LaRouche, Jr.
Chairman
Advisory Council
Warren Hamerman
Chairman
Barbara Boyd
Treasurer

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March 1, 1983
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Hon. John Heinz
Chairman, Subcommittee on
International Finance
Dirksen Senate Building
Washington, DC 20510

Dear Mr. Chairman:

Enclosed, please find testimony for the written record of your hearings held on the IMF quota increase. The testimony consists of a main body expressing our opposition to the quota increase, under any conditions, as well as an appendix on Mexico. The Mexico case study is provided to show the absurdity of the argument that the quota increase will safeguard U.S. exports to Mexico, as has been claimed by numerous official spokesmen.

If there are any problems with this submission, please contact me at the Washington, DC number noted above.

Thank you for your consideration.

Sincerely,

Susan Kokinda

Susan Kokinda
Washington Representative

TESTIMONY OF THE NATIONAL DEMOCRATIC POLICY COMMITTEE

BEFORE THE SENATE BANKING, HOUSING & URBAN AFFAIRS COMMITTEE ON THE PROPOSED AMMENDMENT OF THE BRETTON WOODS AGREEMENT ACT TO INCREASE THE U.S. QUOTA IN THE INTERNATIONAL MONETARY FUND

The National Democratic Policy Committee (NDPC) is strongly opposed to the increase of the United States quota in the International Monetary Fund (IMF) on the grounds that the IMF functions against the national interests of the U.S. and on behalf of the supra-national interests of the British government, the Swiss-based Bank for International Settlements, and other foreign financial blocs.

At this moment in history, the world network of banking and financial systems is de facto bankrupt. No amounts of austerity, nor International Monetary Fund conditionalities policies can make the roughly $800 billion of Third World and East Bloc debt payable. Though the network of old aristocratic families, and their financial holdings, the fondi, are prepared to implement genocide against especially Third World countries, through the Bank for International Settlements (BIS), and the International Monetary Fund, this solution cannot stabilize the world monetary system.

The only feasible policy for the United States at this time is to announced the unilateral remonetization of its gold reserves at $500 per ounce as part of a coordinated effort with other major Western and developing sector governments to create a new world gold-based monetary system, to be detailed below.

The NDPC is a nationally-recognized political action committee of the Democratic Party, certified by the Federal Election Commission. The NDPC's Advisory Board Chairman Lyndon H. LaRouche, Jr., a contestant for the 1980 Democratic Presidential nomination, is one of America's leading economists and manager of the LaRouche-Riemann economic forecast computer model. For the past 13 quarters, since the fall of 1979, Mr. LaRouche's service alone has predicted the continuing declines in U.S. industrial activity since the end of 1979, and consistently provided the only correct forecast of U.S. industrial activity available among the major economic forecasting services internationally.

IN SUMMARY:

--The National Democratic Policy Committee opposes the proposed increase of the United States quotas in the International Monetary Fund under the IMF's pending Eighth Quota Review; opposes the proposed increase of the U.S. contribution to the General Agreement to Borrow of the Group of 10; and opposes any other increase in U.S. funding of the IMF or any other agency or affiliate of the IMF.

--The NDPC furthermore proposes that the Congress request a full report and review by the United States Executive Branch on the uses and proposed uses of United States funds already committed to the International Monetary Fund;

--The NDPC also proposes that the Congress request a full report and review by the United States Executive Branch of all proposals pending and forthcoming before the government of the United States for the re-chartering of the IMF and/or its expansion in any way into a world central bank.

The following testimony will detail the NDPC's contention that the IMF functions against the national interests of the United States including the fact that the IMF and the entire Bretton Woods system of which it is the cornerstone are incapable of handling the current bankruptcy of over $800 billion in developing sector and other national debts which threaten to collapse the international banking system (Part I); that the proposed Eighth IMF Quota Review is only a first step in a broader British plan to establish a "new Bretton Woods" system including a plan to re-charter the IMF into a "world central bank" granting it surveillance over the U.S. domestic economy among others (Part II); and will detail the proposals of the NDPC and Mr. LaRouche for a "New World Economic Order" to be unilaterally proposed by the President and Congress of the United States above and outside the framework of the IMF (Part III).

PART I: THE IMF AS AN INSTRUMENT OF ANGLO-SWISS POLICY

The charter of the International Monetary Fund was authored at Bretton Woods in 1944 by British Chancellor Lord J. M. Keynes, on behalf of the government of Britain and the British crown, and accepted by then U.S. Treasury Secretary Henry Morganthau, Jr. and his deputy Harry Dexter White (later accused as a Soviet spy) acting as agents of British intelligence within the United States.

Lord Keynes' objective was to perpetuate the zero-growth colonial world economic policies of the British Commonwealth and the private British and Swiss banks which financed 19th Century British colonial system, after the political dissolution of the British Empire.

The fundamental purpose of the Anglo-Swiss interests was to slow and where possible reduce world rates of population growth in accordance with the principles of Thomas Malthus, a principle to which America's Founding Fathers were inalterably opposed. IMF Managing Director Jacques de Larosiere, in a speech to the United Nations in August, 1981, openly stated the fact that "A major goal of economic policy" is to ensure "the growth in the world's population can be arrested...massive effort will be required if the world is to be protected from the pressures of a population growing beyind its resources...concentrated in the poorer developing countries."

Lord Keynes' original proposal for the IMF, which would have chartered the IMF as "world central bank" with the power to issue an international currency (the "bancor"), to which the U.S. and other nations would ceed sovereign power over their issuance of national credit. The provision to ceed sovereign powers of central banking to the IMF was deleted from the Bretton Woods charter after opposition in the U.S. Congress.

However, although the United States retains a vote adequate to veto any major decisions in the IMF, the IMF's charter still runs entirely in opposite to President Franklin Delano Roosevelt's expressed post-war policy of "exporting the American industrial system," which would have meant large U.S. industrial trade surpluses as America served as the engine to industrialize the rest of the world.

Since the IMF has offered credit only on condition that nations maintain a "balance of payments equilibrium, war-torn European nations and developing nations alike since 1944 have been denied U.S. industrial goods on anything approaching the necessary scale.

Since 1944 the IMF has used its power to set international credit policy to prevent the industrial revolution in the Developing Sector and to maintain large parts of Asia, Africa, and Latin America as 19th Century colonial raw materials processors in fact. This policy of world credit constriction has destroyed large markets and potential markets for United States.

The national interest of the United States, moral, political, and economic alike, to the contrary, requires the export of the American System of high-growth industrial progress, high-technology innovation, and education throughout the world, to encourage sovereign industrial Republics in natural alliance with the American political system.

The IMF, by the destruction of the economies of the Developing Sector, further now threatens the United States with political turmoil and political alienation of these countries from the United States, as did an IMF program in Iran in 1980. IMF programs in Mexico, Brazil, and other Latin American countries will threaten nations of our own Hemisphere with "political disorder," Russell Marks, President of the Americas' Society, told a journalist Feb. 23.

Colombian President Belisario Betancur accurately portrayed the devastating results of IMF policy in a Feb. 26 speech before the Latin American members of the Group of 77. "The IMF demands measures of its borrowers which, involving austerity and discipline, lead to contraction, and hence to a process of inflation through devaluation... The truth is that current financial mechanisms with their short-term solutions attempt to resolve a debt problem which is insoluble in the short term. As long as this (long term solution) does not happen, renegotiation of the debt only means another twist in the hangman's rope, which will in the end strangle the developing countries, with grave social and political consequences, and with deep repercussions for the industrialized countries and for world peace."

Senator William Proxmire (D-WI) in a speech on the Senate floor Feb. 23 stated clearly that the IMF is destroying American export markets. "Mexico is already sharply reducing its imports," he noted. "Mexico last year slashed imports from the U.S. by $6 billion, costing America 150,000 jobs. Apparently that was not enough. Now IMF will tell the Mexicans to tighten the screws even further...If this IMF technique is applied in Argentina, Brazil, and other countries, the end result of our $8 billion contribution to IMF quota might be the loss of a half million American jobs."

Under the terms of the current IMF program about to be signed by Brazil, for example, "the value of imports will fall by about 17.5% in 1983 or from $19.4 billion to $16 billion," according to the IMF's letter of intent. The memorandum also calls for Brazil to:

Reduce its balance of payments deficit to zero by the beginning of 1983.

Reduce public sector borrowing by a large percent

Reduce internal money supply

Devalue the cruzeiro by over 12.7%.

American political self-interest requires the sovereign control by the United States of the American banking system and the credit and currency of the United States.

However, all current lending programs by the IMF are intended not to benefit recipient nations, but to bail out the insolvent private bank loans of the British and Swiss banks in the $2 trillion off-shore illegal Eurodollar market, legitimatizing the claim of foreign Eurodollars, which are not legal tender in the United States, upon the currency of the United States;

The IMF is thereby granting a defacto United States and government guarantee to the private loans of not only American but British, Swiss and other foreign private banks;

Furthermore, these private banks including major U.S. banks, have, jointly with the IMF, formed a "creditors' cartel" known as the Ditchley Group, illegal under the U.S. Sherman and Clayton anti-trust acts, which is now actively run by the IMF, and which has already established the informal policy that no new international loan will be made by United States and other private commercial banks without IMF control and supervision;

This IMF direction of United States banking practise constitutes a violation of United States national sovereign control over the credit of the nation;

The proposed expansion of IMF quotas, the IMF General Agreement to Borrow, and other IMF loan facilities will constitute a further tax upon the United States government and taxpayers by the IMF, to expand the power of the IMF to control the sovereign credit of the United States, to run a creditors' cartel illegal under U.S. law, and to unlawfully guarantee the portfolios of foreign private banks with U.S. government funds;

PART II. QUOTA EXPANSION IS ONLY THE FIRST STEP

Worse, the proposed increase in IMF quotas and related funding is widely known to be only the first step in a proposal by the British government to re-charter the IMF and expand it formally into a "world central bank," as originally proposed by Britain's Lord Keynes in 1944. This would constitute a defacto supra-national world government and thus direct the sovereign international credit of the United States.

Vice President George Bush, Secretary of State George Shultz, and Treasury Secretary Donald Regan, the same individuals publically promoting the IMF quota and related funding expansions in the U.S. Congress today, have also privately already proposed the establishment of the IMF as such a world central bank before the International Economic Policy task force of the Cabinet of the United States;

The centerpiece of this new system is to be the establishment of the International Monetary Fund as a form of "global MAC," as Lazard Freres partner Felix Rohatyn told Business Week in a Feb. 28 feature, a corporation to take the world under receivership just as Rohatyn's Big MAC took New York City under receivership.

"The reality of the situation is that a significant part of the approximately $700 billion now lent to the Third World and Eastern bloc will come back, if ever, only over a long period," Mr. Rohatyn told readers bluntly. "Instead of maintaining the fiction that these are short-term, high-interest loans, it might be better... to stretch out exisiting lonas to 25 to 30 years at much lower interest rates."

Under the MAC in New York City, as Rohatyn outlined it to Business Week Fed. 28, the debts which the City could not pay were swaped by the banks to MAC. MAC then functioned as a creditors' cartel collection agency, in particular appropriating a revenue stream, "which the City could not touch," to back up the debt. The City's economy was destroyed.

Under a global version of MAC, Rohatyn proposes the IMF set up a "Global MAC fund" from which it will issue the banks $300 billion worth of IMF 25-30 year long term bonds. The banks will then swap the IMF $300 billion of their short and medium term loans. The banks will then be rid of the loans, although they'll earn less on the bonds, and the "debt bomb" threat by any debtors cartel against the banks greatly reduced.

The global MAC would "establish a revenue stream," Rohatyn writes, by stealing Third World countries' revenues from "sales of their commodities or other kinds of income in a way that would service their long-term bonds in an orderly manner."

The IMF will then be in the position of "enforcer," and governments who back it will have to send in the troops to collect on the new IMF bonds if countries don't pay. Lawyers have suggested that multinational banks who finance Third World countries' exports could simple "sequester" portions of the countries' earnings on behalf of the IMF.

Under such proposed IMF re-chartering the United States itself would be subjected to supra-national "multilateral surveillance" by the IMF over U.S. domestic fiscal, monetary, industrial, and general economic policy and subjected to extensive policies of IMF conditionality over the sovereign domestic policies of the United States.

In fact, the major topic of the IMF's Feb. 10-11 Interim Committee meeting in Washington was not the Eight Quota Review, but discussion of how to impose IMF "surveillance" over the budget of the United States. Sir Geoffrey Howe, the head of the IMF's Interim Committee and Chancellor of the British Treasury, told Parliament before the IMF Interim Committee meeting that the major problem facing the world monetary system is the "size of the U.S. budget," and called for U.S. defense spending to be cut. The London Daily Telegraph Feb. 7 reported the circulation of a secret IMF staff memo calling that the U.S. deficit the "greatest threat" to the rest of the world.

The head of the IMF Financial Studies Division Feb. 9 outlined the budget cuts in the IMF's secret memo as follows:

1. There must be a "large decrease" in U.S. industrial investment (which fell some $60 bn last year).

2. There must be a doubling of the proposed cut in the Defense Budget for 1983 compared to the previous plans for the 1983 budget, or a cut of some $36 billion.

3. Social Security must be cut "at least" as proposed by the Greenspan Commission on Social Security, which proposes a $5 bn cut in Social Security payments in 1983. IMF sources indicated that they want much bigger cuts than than, but that it may be too late in the 1983 fiscal year to get them.

IMF officials say the aim is to keep the U.S. permanently in a DELIBERATE RECESSION. There must be "no recovery" in the U.S., the author of the IMF's secret memo said recently. "For this to work, there must be no credit in the economy for anything at all but the budget. It can continue, AS LONG AS THE U.S. ECONOMY

REMAINS VERY, VERY WEAK," the IMF man stated. "If you tell me the U.S. private sector is going to have any new demands for funds, I would laugh. U.S. industry will not be getting much in the way of new funds."

"De Larosiere has been brutally frank," a British official said at the meeting. "The US must cut its budget, because the fate of the world economy depends on rapid US action." De Larosiere, he said, has even organized many Third World and other nations agianst the US, by charging that the U.S. budget causes high world interest rates. "De Larosiere has set the entire meeting against the U.S.," the British official said. "In fact, the only thing upon which all the Finance Ministers of the world can agree, is that the U.S. budget deficit is a threat to the world."

De Larosieres' unprecedented attack on America was even referred to in the IMF's public Communique, which stressed "the importance of reducing fiscal deficits in a number of countries." De Larosiere refused to deny the charge by NDPC representatives that he intends to put the U.S. under an IMF program.

U.S. Treasury Secretary Donald Regan was asked by NDPC representatives Feb. 11 whether the US must have an IMF program. "That's not a bad idea," he stated. "We used to have one, you know."

PART III. ALTERNATIVE POLICY: REMONETIZE U.S. GOLD RESERVES

The only possible measures to deal with the extent of the current world crisis will be unilateral American measures completely circumventing the International Monetary Fund and re-establishing American international financial power.

As the first step, NDPC Advisory Board Chairman Lyndon H. LaRouche has proposed that America mobilize its gold reserves and set up a new American world monetary system. "Whoever is in control of the current world monetary crisis can striaghten it out," LaRouche said. "But the U.S. is dangerously losing any control." LaRouche suggested President Reagan address the nation on television and announce that he is putting the dollar back on a gold reserve basis at $500/oz, and that "from this standpoint of US national interest, he will negotiate directly with Third World debtor countries to reorganize the world monetary system to foster wealth-creating development." Congress, which is vested with control over the credit and currency of the U.S. under the Constitution, can do the same.

Under the U.S. gold plan America would remonetize its some 260 million ounces of gold at current market prices, which at $500/ounze would be a gold reserve of $132 billion. The gold would be used for trade payments to other world governments, to expand U.S. foreign trade and bolster the U.S. economy and the dollar.

1. The U.S. would offer to settle its imbalances in current international trade payments IN GOLD, on a goverment-to-goverment

basis, to those nations which agreed to a like gold policy. The first three points would completely bypass the IMF and make it irrelevant and obsolete.

2. The U.S. would negotiate directly with the Third World developing nations for a moratorium on their unpayable old debts, and then issue some $100-200 billion in new gold-backed U.S. bonds as export credits to the Third World. This would create a boom in U.S. industrial exports, jobs, and restart Third World economies.

3. Under the agreement, the U.S. would help American banks to renegotiate the old, unpayable debt into 20-30 year bonds, which the banks could discount to receive new gold-backed Treasury notes, provided they use them to make useful trade loans. The U.S. banks would thus take some losses on the old debt, but be stablized and given a major new source of profitable loans.

The U.S. banks' independent political power, however, to dictate policy to the U.S. government, would be destroyed.

The British, Swiss, and other foreign banks who now speculate in U.S. dollars in the offshore $2 trillion Eurodollar market would be left out of the arrangement and bankrupted, in a massive re-assertion of American international economic power.

4. Reform the domestic U.S. banking system by first nationalizing the Federal Reserve into a "Third Bank of the U.S.," controlled by the U.S. Treasury. The Treasury alone shall then have the power to issue domestic currency, which shall be issued as gold-reserve-denominated Treasury notes. Since the Federal Reserve's current printing of money with no limits or economic basis is one of the chief causes of inflation, and allows the offshore banks of the $2 trillion Eurodollar market in London to

continue to speculate in the U.S. dollar, this will mean an end to monetary inflation.

5. Private banks are to be prohibited from issuing currency, or from making any loans except loans which they can as a percentage of deposits placed with them by the public. This eliminates the inflationary "Keynsian multiplier," in which banks now make loans worth many times their deposits, in effect inventing private money. This will be sharply anti-inflationary, since such "private money" makes up a huge part of credit in the U.S. at this time.

6. To restart the economy without deflation, several hundred billion of new gold-backed U.S. Notes shall be issued as domestic money, but only to banks who agree to use them as a percentage of loans to be made for genuinely productive purposes such as industrial and agricultural investment, production, and trade. Such loans shall be issued at nominal interest rates between 2-4% annually, and will result in a U.S. economic boom dwarfing the revival of the economy during World War II, without war.

MEXICO FACT SHEET: HOW THE IMF IS DESTROYING AMERICA'S THIRD LARGEST TRADE PARTNER

INTRODUCTION. Mexico's economic crisis is being frequently cited by certain Administration spokesmen and others as a key reason why there must be an increase in International Monetary Fund quotas. Donald Regan, for instance, in mid-February testimony to Congress, declared that Mexico's economic crisis had "cost the jobs of 250,000 Americans", because Mexico had so drastically cut imports from the United States. Between the last quarter of 1981 and the last quarter of 1982, he stated, Mexican imports from the U.S. had dropped 60 percent. He and others defending the IMF quota increase argue that increasing the flow of IMF resources to Mexico will allow Mexico to rebuild its imports from the United States.

This fact sheet will demonstrate three points: 1) Mexico's economic crisis was not caused by "growing too fast", "over-ambitious development projects," or "corruption". It was caused by Volcker's high interest rates, the declining demand for oil in failing industrialized economies, and politically-motivated flight capital operations. 2) The IMF and related agencies, especially the Federal Reserve, over the past year dictated a policy of drastic cuts in Mexican spending and imports as their "solution" to the crisis formed by these external pressures. THE DRASTIC DROP IN U.S. EXPORTS TO MEXICO FROM $15.5 BILLION IN 1981 TO APPROXIMATELY $8.0 BILLION IN 1982 WAS THE RESULT OF IMF-DICTATED POLICY. 3) The current IMF program for Mexico locks Mexico into even further cuts in imports from the U.S. Even more serious, it guarantees levels of political and social unrest in Mexico that could easily threaten America's southern border.

PROPOSING TO HELP RESTORE MEXICAN IMPORTS FROM THE UNITED STATES WITH AN INCREASE IN IMF QUOTAS IS LIKE ATTEMPTING TO REDUCE THE NUMBER OF EXECUTIONS IN A TOWN BY INCREASING THE SALARY OF THE HANGMAN.

I. CAUSES OF THE MEXICAN CRISIS.

From 1977 through 1980, Mexico kept the growth in its foreign debt under control, adding something like $3-4 billion per year. Because of rapid overall economic growth of 8 percent per year and even more rapid growth in exports, foreign debt in fact proportionately SHRANK in relations to GNP and foreign earnings.

In 1981,

*Oil prices leveled off and then began to fall. Mexico lost an approximate $5 billion in expected revenue;

*The third year running of unprecedentedly high international interest rates, forced up by U.S. Federal Reserve policy, shot Mexican foreign debt payment through the roof. While Mexico's trade deficit between 1980 and 1981 rose from $3.2 billion to $3.7 billion, an increase of 15 percent, direct foreign financial payments increased from $5.9 billion to $8.9 billion, for a 50 PERCENT INCREASE.

*Starting in 1981, and growing to a flood in 1982, flight capital poured out of the country. The 1981 Bank of Mexico report showed $5.5 BILLION in "errors and omissions," the classic category where flight capital gets recorded. By the time Lopez Portillo slapped on full exchange controls Sept. 1, 1982, a minimum $20 BILLION had left the country.

The giant rise in debt from a total private and public debt of $48 billion at the end of 1980 to $64 billion at the end of 1981 and then $80 billion at the time of the exchange controls was due to government efforts 1) to finish priority investment projects (involving unprecedented levels of U.S. imports - $15.5 billion in 1981, up from just $5 billion two years before), and 2) keep up with the demand for dollars generated by the flight capital. DURING THIS PERIOD, MEXICO WAS UNDER INTENSE PRESSURE FROM THE U.S. STATE DEPARTMENT AND IMF CIRCLES NOT TO IMPOSE EXCHANGE CONTROLS, THE MEASURE WHICH AT A STROKE COULD HAVE ALLOWED MEXICO TO KEEP ITS FOREIGN BORROWING DOWN BY AS MUCH AS $20 BILLION.

When Lopez Portillo finally did impose exchange controls, he came to the U.S. Congress to try to get some of the money back. In his Sept. 1, 1982, State of the Union address, he called for the creation of a special bilateral commission of U.S. and Mexican congressmen, to work out ways to "recyle" the flight capital and get the debt paid. THERE WAS NO PERCEPTIBLE SIGN OF INTEREST FROM THE ADMINISTRATION OR THE CONGRESSIONAL LEADERSHIP.

The combination of declining oil revenues, increasing interest rates, and flight capital, ACCOUNT ALMOST TO THE PENNY for the tremendous run-up in Mexico's foreign debt between 1980 and 1982. The problem was NOT the "over-ambitious growth" which brought the United States its only bright spot in a world panorama of declining trade.

II. IMF POLICY IS TO CUT MEXICAN IMPORTS

DR. JULIO GONZALES, IMF DIVISION CHIEF FOR MEXICO AND THE CARIBBEAN, MARCH, 1982: "We are telling the banks to hold the line on lending to Mexico and clamp down now, TO TRY TO GET THE IMPORT LEVELS DOWN. If imports are not cut, and wages, then there will be an absolute stte of chaos in Mexico by the middle of the year... So they must begin the austerity program now."

CLAUDIO LOSER, IMF EXCHANGE AND TRADE RELATIONS BUREAU, MARCH, 1982: "Mexico has already put in place the basis for a real austerity program with the (February) peso devaluation. By devaluing the peso by 30 percent they have already set the conditions for A REDUCTION IN THEIR IMPORTS BY 30 PERCENT, WHICH IS WHAT MEXICO MUST DO. That will mean cutting about $8.0 BILLION in imports, compared to a $24 billion import bill for 1981. If they follow this program, WHICH WE SUPPORT, there will be quite a severe program of austerity."

The toll of major development projects under this IMF policy, both before and after the IMF formally took control of Mexico's economy in December, 1982, includes:

* The Mexican nuclear program. In June, 1982, Mexico cancelled bidding on two new reactors, a total $3 billion contract. Three U.S. companies (General Electric, Westinghouse, and Combustion Engineering) were leading contenders for the contract. Completion of the first unit of Mexico's only existing nuclear project, Laguna Verde, is now scheduled for 1987, though construction is 75 percent complete. As of October, 1982, all work on unit two ceased, and further funds for it were eliminated from the 1983 budget.

*Construction of industrial ports. Four of these were initiated in the late 1970's, vital to break transportation bottlenecks and spread Mexico's population out from the Mexico City area. Under the current IMF budget, Mexico has cut the ports program by 75 percent.

. *Large irrigation works. The Water Plan of the Northwest (PLHINO), approximately half finished, is to bring large quantities of water from Jalisco and Nayarit, half way up Mexico's Pacific Coast, to the fertile but arid plains of Sonora and northern Sinaloa. Previously completed water projects in the region have permitted the growth of Imperial Valley-style modern agriculture in Sonora. The PHLINO would double the amount of land under irrigation. ~~Workers and farmers in the region have found~~ out that under provisions of the IMF budget, ALL EARTHMOVING AND OTHER HEAVY CONSTRUCTION EQUIPMENT IS TO BE REMOVED, TO BE REPLACED WITH PICKS AND SHOVELS. The completion date has been moved back into an undetermined future. The IMF pressure on other advanced irrigation projects has led to the cancellation of center-pivot systems that were to be imported from Nebraska and other mid-West states.

III. THE CURRENT IMF PROGRAM LOCKS MEXICO INTO FURTHER IMPORT CUTS

The "foreign exchangye budget" announced by Finance Minister Jesus Silva Herzog in December 1982, under the IMF program, is based on expected exports of $20 billion and $5 billion in net new borrowing (a limit established in the IMF accord). The resulting total of $25 billion, announced Silva Herzog, will be apportioned $14 BILLION FOR DEBT PAYMENTS AND $11 BILLION FOR IMPORTS. The $11 billion is FULLY $5 BILLION BELOW 1982'S CATASTROPHICALLY LOW LEVEL; it is $6 billion below minimum import requirements to keep Mexican industry running at existing levels, according to a late-January government study. Dollars from open-market currency trading can not possibly compensate. Only $200 million entered from this source in the first six weeks since exchange controls were lifted, and most of that is being skimmed by the government to pay arrears on interest payments of private sector foreign debt.

On Feb. 7 Miguel Mancera Aguayo, head of the Bank of Mexico, announced that expected interest payments for the year might be as low as $10 billion, because of declines in interest rates. However he noted that in fact $15 BILLION will leave the country in financial payments, because $5 billion is needed to "restore suppliers' credits." He estimated total foreign exchange inflow for the year at $26 billion; the amount left for imports STAYS AT $11 BILLION in his calculations, the latest available. It is to be noted that these calculations are highly optimistic: 1) the increasing spreads Mexico has to pay over the London Interbank Rate (LIBOR), plus large fees to banks involved in restructuring the short- and medium-term debt, help offset the current decline in interest rates -- which may themselves be temporary. 2) the drop in oil prices beginning in mid-February will reduce Mexican export earnings by a minimum of $2.5 billion.

CONCLUSION

The IMF program, based on 1) placing debt payment over imports; 2) drastic slashes in government spending; 3) the elimination of capital-intensive development projects; 4)high internal interest rates which penalize productive investment; and 5) and open-market peso operations which encourage new flights of capital, GUARANTEES CONTINUED SLASHES IN MEXICAN IMPORTS FROM THE UNITED STATES, AS WELL AS CONDITIONS OF ECONOMIC COLLAPSE OF SUCH A MAGNITUDE THAT INTERNAL UPHEAVAL IS LIKELY WITHIN SIX MONTHS.

The only program to restore U.S. export levels to Mexico and avert an internal upheaval is 1) re-schedule Mexican debt over a 20 to 25-year period, via new, gold-backed bond issues, and 2) ~~extend new credit FOR LARGE-SCALE INFRASTRUCTURE, ENERGY, INDUSTRY~~ AND TRANSPORTATION PROJECTS (no lending to underwrite capital flight, speculation, or unnecessary consumer imports). With such a program, both the Mexican and the U.S. economies would soon be on the mend.

30-30-30

FINANCING DEVELOPMENT IN THE THIRD WORLD

Statement by G. F. Joklik, President

Kennecott

SUMMARY

The economic growth of the Third World depends on financial support from the industrialized nations. Third World growth, in turn, provides expanded markets for the industrialized nations' products. This economic interdependence is jeopardized when the financial resources of the industrialized nations are used to support fundamentally uneconomic Third World development projects. The consequences of such investment practices are to deprive the Third World of some of its best growth potential, penalize economic industries in developed countries and endanger repayment of many of the investments.

The adverse effects of the misallocation of credit are evident in the worldwide copper market. International financial support of Third World subsidized copper production has now become common and has caused an oversupply which has depressed world copper prices to levels below the costs of even the more economic producers. Significant production cutbacks and high unemployment in the United States copper industry have resulted.

At the same time, the economies of some Third World countries have become overdependent on copper production. The need for export earnings has prompted Third

World producers to actually increase their copper output during the same period in which United States production has been contracting. In order to achieve these production levels, under adverse market conditions, the Third World government owners have subsidized copper operating losses, while substantially increasing their external borrowing.

The root of the problem is the failure of many lending institutions to consistently apply reasonable standards — standards which are based on project economics and reflect the impact of projects on the economies of the borrowing, as well as the lending, nations. Appropriate standards would assess the intrinsic viability of projects and screen out those which are made to appear viable only by foreign government support or subsidy.

As the largest national contributor to the development of the Third World, the United States is the principal underwriter of foreign subsidized production. Accordingly, the United States should take the lead role in encouraging the widespread adoption of lending standards that will promote the efficient growth of the developing economies of Third World countries. The United States can exert influence on foreign lending standards of government lending agencies and domestic commercial banks, and can encourage official agencies and the commercial banks of other principal lending countries to follow suite. As a major voting and contributing member of the multinational lending organizations, the United States can favorably influence their policies and practices.

Action should be taken now, before economic recovery from the current recession refuels the Third World's rapid growth objectives and pushes Third World development even further ahead of sound planning.

INEFFICIENT DEVELOPMENT

Increasing worldwide economic interdependence links the industrialized nations with the developing countries of the Third World. Industrial societies rely on the Third World for raw materials and export markets. In 1981, for example, the Third World countries purchased over 36% of the merchandise exports of the United States. A 50% variation in this flow of exports to the Third World amounts to 2% of the total United States GNP — possibly enough to mean the difference between healthy growth in the United States and weak or no growth — the difference between prosperity and stagnation.

At the same time, Third World growth imposes some industrial dislocations on the economies of developed countries. The United States copper industry provides an example. Due to the worldwide recession, the price of copper, corrected for inflation, fell in the summer of 1982 to its lowest level since the early 1930's. The worst impact of this market collapse was felt in the United States and Canada. United States copper production dropped by 36% between July 1981 and July 1982, and employment in the copper industry declined by 40%, idling 17,000 workers. The Third World copper producers, by contrast, increased their output of copper by 7% during the same period.

It would be shortsighted for the industrialized nations to protect domestic industries from legitimate Third World competition. In the case of copper mining operations, for example, higher grade orebodies give some Third World producers a competitive edge over domestic producers. Tariffs, import quotas, stockpiles or subsidies may serve as stop-gap measures, but they cannot provide effective protection over the long term. Such measures artificially prolong the life of inefficient domestic industries, thereby weakening the incentive for the industrial economies to adapt in a changing world.

The same logic applies to foreign investments by these industrialized nations. Projects that are not inherently economic should not be supported or undertaken. Again turning to copper as an example, one can point to several Third World copper mines which are far less efficient than domestic copper mines, but are supported by foreign financing. Uneconomic projects ultimately consume more resources than they provide, and divert limited financial resources from better alternative uses. Along with their role in financing the development of the Third World, the industrialized nations bear a responsibility to themselves and to the rest of the world not to encourage inefficient development.

The copper industry provides a clear-cut example of inefficient investment in the development of the Third World. The principal Third World copper producers are Zambia and Zaire in Africa and the Latin American nations Chile, Peru, and Mexico. In 1981 these five countries accounted for 42% of Free World copper mine production (Table 1). The United States produced 24%.

Table 1

Principal Third World Copper Producers

Country	1981 Copper Mine Production (000 tons)	Percent of Free World Production
Chile	1,192	16.6%
Zambia	648	9.0
Zaire	557	7.8
Peru	361	5.0
Mexico	253	3.5
TOTAL	3,011	41.9%

Source: World Bureau of Metal Statistics

Zambia and Zaire are now overly dependent on the copper industry. This relationship is illustrated in Table 2 in which the proportion contributed by copper to the export earnings of the principal Third World producers is listed. Zambia and Zaire head the list: Zambia is dependent on copper for nearly all export earnings and Zaire relies on copper for nearly one-half of export earnings. As a result, the wide fluctuations in the price of copper cause an extremely variable flow of earnings to these countries.

Table 2

Dependence on Copper
for Foreign Revenue in 1981

Country	Copper Contribution (% of Total Export Earnings)
Zambia	95%
Zaire	47
Chile	43
Peru	16
Mexico	2

Sources: World Bank and International Monetary Fund

This is not to say that the very substantial copper resources of these African countries should have gone undeveloped. Rather, it was the lack of a balanced development program, the overdevelopment of copper to the neglect of other segments of the economy, which was ill-advised.

The aftermath is with us today. To provide export earnings, Third World countries are obliged to continue to produce as much copper as possible, even at those mines which are inefficient and which, under the current depressed market conditions, are incurring large losses; and, in order to subsidize this inefficient production, Third World producers must rely increasingly upon external financing (Table 3). The problem is self-perpetuating and continually growing.

Table 3

Increase in External Debt
of Third World Copper Producers

	External Debt (Billions of Dollars)		Debt Service as a % of Total Exports	
	1981	1982	1981	1982
Chile	$15.5	$20.0	45%	156%
Zambia	2.0	2.2	36	51
Zaire	4.1	4.5	29	76
Peru	8.3	9.0	58	50
Mexico	65.0	80.0	38	112

Source: Brook Hunt & Associates Ltd.

The degree to which the problem has escalated is further illustrated in Table 4. As a "lender of last resort" the IMF has a strong hand with borrowers who have no alternative source of funds; nevertheless, as the table shows, the amount of IMF borrowings by Third World copper producing countries has been generally increasing in recent years, particularly in 1982.

Table 4

IMF Borrowings
by Third World Copper Producers
(Outstanding Balances, Millions of Dollars)

	1975	1976	1977	1978	1979	1980	1981	Est. 1982
Chile	$387	$467	$366	$348	$179	$122	$49	$880*
Zambia	89	110	113	318	416	396	729	620
Zaire	86	209	247	260	248	235	345	413
Peru	--	185	205	334	491	474	388	595
Mexico	--	371	509	298	136	--	--	1,000*

* Approved, partly drawn.

Source: IMF International Financial Statistics

The heavy dependence of these Third World countries on the copper industry was not inevitable and is not irreversible. Important sectors of their economies are underdeveloped. For example, in Zambia and Zaire commercial agriculture presents an opportunity for diversification. Both countries are increasingly dependent on agricultural imports, yet both have large areas of unused arable land, and a study supported by the World Bank reports that Zambia has an effective comparative advantage in at least three major crops — groundnuts, tobacco and cotton.

The major copper producing countries in Latin America also have significant diversification opportunities. The timber resources of southern Chile, for example, remain relatively undeveloped. Agricultural export potential in the mid-south of Chile could be developed for markets in the northern hemisphere, where seasons are reversed.

Despite the rationale for diversification, and despite the worldwide oversupply of copper, several new copper projects in Third World countries have been slated for development, provided that financing can be arranged. In Table 5 are listed copper projects which could be developed in Chile and Peru, between 1983 and 1990, if financing efforts were successful. The projects are grouped according to the estimated prices necessary to economically justify the projects, based upon a 15% before tax return on the capital invested. It is likely that copper prices will temporarily increase, as they have in past cyclical upturns, and move into ranges that are required to provide this return on investment in these properties, but it is not likely that copper prices will attain such levels on a sustained basis during this decade.

Table 5

Prospective Copper Projects

Production Cost (1982 $/lb)	Project (Property & Country)	Added Capacity (000 Tons/Year of Copper)
$1.20 to $1.50	Andacollo, Chile	320
	Los Pelambres, Chile	
	Quebrada Blanca, Chile	
	Antamina, Peru	
Above $1.50	Disputada expansion, Chile	250
	Michiquillay, Peru	

Source: Metals & Minerals Research Services, London

Lenders need to evaluate projects such as these against sound economic standards. Project financing should be contingent on reasonable expectation of a satisfactory return on investment, without the aid of financial or operating subsidies. This criterion would provide an objective basis for screening projects on economic rather than political grounds, for comparing development alternatives and for allocating limited capital resources.

THE LENDERS

The commercial banks of the United States and other industrialized countries provide the largest source of borrowings for principal copper producing countries of the Third World (Table 6). Commercial banks hold approximately 72% of the external debt incurred by these countries. Multinational lending organizations and governments constitute the other major sources of financing.

Table 6

Structure of External Debt of Third World Copper Producing Countries (Chile, Mexico, Peru, Zaire and Zambia)

Commercial Banks		72%
United States	30%	
Non-U.S.	42%	
Multinational Lending Institutions		13%
World Bank & Affiliates	3%	
Inter-American Development Bank	4%	
International Monetary Fund	3%	
Other Multinational Lenders	3%	
Governments		15%
United States	3%	
Non-U.S. (est.)	12%	
TOTAL		100%

Sources: Federal Reserve Board (Statistical Release E. 16), Bank for International Settlements, U.S. Treasury, World Bank (Annual Reports), Inter-American Development Bank (Annual Reports), IMF International Financial Statistics, IFC (Annual Reports), Brook Hunt & Associates, and Organization for Economic Cooperation and Development.

The amount of money that these lenders have invested in copper projects, both directly and indirectly through loans to governments, is set out in Table 7.

Table 7

Financing of Government-Owned Copper Producers

		Billions of Dollars
Chile	- Codelco	$ 1.9
Zambia	- ZCCM	1.0
Zaire	- Gecamines	1.1
Mexico	- Cananea	.4
	- La Caridad	1.3
Peru	- Centromin	.8
	- Minero Peru	.6

Source: Individual Company Financial Statements, and Citibank Mining Division

The classes of lenders listed in Table 6 pursue different missions and adhere to different charters. Since they are subject to and respond to different motivations and pressures, their lending criteria are not consistent.

Commercial banks judge lending opportunities primarily on the basis of the borrower's ability to repay. Although factors such as project economic viability and overall market conditions generally influence their judgment, these may not be the overriding factors when adequate assurance of repayment can be obtained through guarantees or subsidies of a sovereign government.

The incentive to press for thorough project evaluation also may tend to weaken under the pressure of competition for loan business. Banks are at times encouraged by various interested parties to consider preferentially loans that build international business, enhance access to export markets, or maintain supplies of raw materials from the Third World. But, once a lending decision ceases to be firmly grounded in project economics, based on the best information available, the risk of the project is increased. In an economic downturn, the consequences of such risks may impact banks, strain the economies of the industrialized nations, and impede progress of development in the Third World.

Although commercial banks carry the largest share of development financing, the **multinational lending institutions** are also instrumental in the promotion of Third World economic development, often in consortia with commercial lenders. The International Bank for Reconstruction and Development (World Bank) and its affiliates — the International Development Association (IDA) and the International Finance Corporation (IFC) — finance Third World development projects. Following similar objectives, the Inter-American Development Bank (IDB) lends to finance development projects in Latin

America. The International Monetary Fund (IMF) also plays an important role in Third World financing, by providing loans to governments during temporary balance of payments crises. Taken together, the policies and practices of these multinational lending organizations can substantially influence the direction of Third World development.

During times of world financial stress, IMF loan conditions tend to be adopted by commercial banks in their own lending to affected countries. Consequently, at times, the IMF can influence Third World access to money out of proportion to its own direct lending ability. In view of this, a strong United States policy stance is appropriate in favor of rigorous IMF loan standards uniformly applied through time.

Direct **government lending** constitutes the third significant source of financing for Third World development. Debt held by the United States government includes loans by the Export-Import Bank, Commodity Credit Corporation, Overseas Private Investment Corporation, Department of Agriculture (Public Law 480 loans), Department of Defense, and Agency for International Development. The activities of one of these agencies, the Export-Import Bank, deserve further comment.

The Export-Import Bank supplements commercial bank lending to facilitate and aid financing of United States exports. Virtually all the larger Free World countries have similar agencies to aid their exporters. The Bank is supposed to consider the net impact of a loan on the United States economy, but in practice, this effort is subject to interpretation; influence may be brought to bear by companies wishing to make export sales and arguing that Bank disapproval of a loan for capital goods would not stop an ill-conceived project, but merely shift the sales to other countries. To counterbalance such influence, there is a need for strong policy guidance of Export-Import loans.

RECOMMENDATIONS FOR ACTION

As the largest national contributor of project financing for the Third World, the United States has means of encouraging the adoption of a universal lending standard that will promote efficient growth. The degree of influence the United States can bring to bear, and the mechanism for applying this influence, vary according to classes of lending institutions.

Certainly, the United States government can exert influence on the foreign lending policies of United States commercial banks in several ways. Standards can be imposed on United States government lending agencies by direct legislative action. In the case of multinational lending institutions, the United States can guide lending practices through votes on governing boards, and by conditioning future capital subscription on reasonable performance (Table 8). Finally, the United States cannot directly control the lending of either foreign commercial banks or foreign governments, but attempts could be made to influence them through negotiation of international agreements. Thus, by establishing a coherent lending policy for Third World development, and by effectively coordinating the application of this policy among the various sources of development financing, the United States can influence the allocation of capital resources.

Table 8

United States Share in Multinational Lending Institutions

Lender	Voting Share (%)	Capital Share (%)
World Bank & Affiliates		
World Bank	21	22.4
International Development Assoc.	19	33.7
International Finance Corp	29.5	31.7
Inter-American Development Bank	35	35
International Monetary Fund	19.6	19.6

Sources: Federal Reserve Board (Statistical Release E. 16), Bank for International Settlements, U.S. Treasury, World Bank (Annual Reports), Inter-American Development Bank (Annual Reports), IMF _International Financial Statistics_, IFC (Annual Reports).

Therefore, it is recommended that the United States undertake a coordinated program of action to control and direct foreign lending for Third World development. This program should be based on a two-part project lending standard:

> First, and most important, a project evaluation standard which assesses the inherent economic viability of a project, without the influence of host nation guarantees or subsidies, and
>
> Second, a test in which the overall, long-term economic development of the host nation, rather than the economic merit of the project itself, is assessed.

The first part of this two-part standard is amenable to conventional quantitative analysis; the second part can employ quantitative techniques, but will necessarily be more judgemental. Accordingly, the first test should dominate the decision and, if properly applied, free market forces should, in themselves, help assure that the objective of the second test will be met.

The first of the two parts is also, of course, firmly rooted in past practice of private industry. The second part is rather more innovative, although there is some precedent for this general approach in the World Bank's lending practices and Structural-Adjustment lending program, complemented by the IMF conditional loans.

The United States could act to implement this program by pursuing the following:

1. By act of Congress, require United States government lending agencies to adopt a two-part project lending standard as described above.

2. Exert influence upon United States commercial banks to place increased reliance upon the two-part project lending standard.

3. Through diplomatic initiative by the Secretary of the Treasury, attempt to negotiate adoption of the two-part lending standard by official agencies and commercial banks of principal lender countries.

4. By policy statement and action, as a party to the activities of multinational lending agencies, encourage the development of Third World economies in the most efficient manner possible.

   Specifically:

   (a) Promote, through voting, lending agency policies that further the efficient use of resources in the development of the Third World.

(b) Condition future United States subscriptions of capital on the lending agencies' effectiveness in furthering Third World development along efficient lines, as determined by the Secretary of the Treasury.

Now is the time for the United States to begin a program of action. Although the worldwide recession currently exerts discipline on lenders, inefficient allocation of capital is apt to recur once the recession ends.

Clearly, American industry and employment would benefit from a reduction of subsidized foreign competition, and the Third World countries would benefit from more stable and rational development.

March 8, 1983

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CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

HILTON DAVIS
VICE PRESIDENT
LEGISLATIVE AND POLITICAL AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062
202/463-5600

March 7, 1983

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the U.S. Chamber's over 230,000 members, I respectfully urge you to support the Administration's request for an increase in the lending resources of the International Monetary Fund (IMF) now under consideration by the Congress. This request consists of approximately $8.4 billion in new U.S. funding: $5.8 billion for the U.S. share of the IMF quota and $2.6 billion in new commitments for the General Arrangements to Borrow.

The Chamber's Board of Directors, on February 9, 1983, expressed strong support for an increase in the Fund's quotas as well as an enlargement and expansion of the General Arrangements to Borrow.

At this critical time, when the international financial system is under severe strain, additional resources will enable the IMF to continue to play a key role in maintaining a stable international financial system which is essential to the free flow of goods and services. Current IMF funds are inadequate to meet the unprecedented demands by member countries.

The Chamber supports the requested increase for the following reasons:

- o World economic stability is threatened by the staggering debt problems of the developing world. The IMF plays a vital role in promoting international economic stability by providing resources to members in support of their efforts to overcome short term balance of payments problems and to implement sound economic adjustment programs.

- The developing world is critical to the U.S. economy. More than 40 percent of exports of U.S. goods and services and one in 20 manufacturing jobs depend on sales to developing countries. Healthy markets overseas mean opportunities for sales of U.S. goods and services.

- The U.S. share of the increase does not result in net budget outlays, nor does it increase the budget deficit. The economic costs occur only when the IMF needs dollars and when the U.S. government must borrow to raise the funds.

- The U.S., at a relatively low cost, exercises considerable leverage within the Fund to insist on necessary corrective actions by debtor nations.

- The IMF has proved itself to be an effective instrumentality. It is not an aid institution. In effect it lends money; it does not make grants. Operating expenses are paid entirely from the interest, or "charges," on the use of IMF resources. All loans made by the IMF have been repaid; there has never been a default.

It is unfortunate that this question of an increase in the IMF's resources should come at this time of constraint and hardship in our own economy. However, circumstances -- mainly the current world-wide recession -- have led to increased global debt problems. The United States has few options available to resolve these problems. To do nothing in these circumstances would have serious adverse consequences for the free world economic system, our general political and security goals, and, in a direct way, on the U.S. economy. Our economy cannot afford the risk of a major threat to the stability of the international financial system, or of a breakdown in international trade and capital flows.

For these reasons, the U.S. Chamber supports the current request to strengthen the resources and role of the IMF as one of the best options available to deal with this problem in the short term.

Cordially,

Hilton Davis

Hilton Davis